SUPREME COURT, U. S.

OCT 20 1973

MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1973

No. 73-676

INDUSTRIAL LIFE INSURANCE COMPANY,
Petitioner,

versus

U. S. A., CIVIL CASE NO. ...., Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Respectfully submitted,

Industrial Life Insurance Company.
CLAYTON SCYPHERS,
Member of Fourth Circuit
Court Bar,
Post Office Box 74,
Gaston, South Carolina.

The R. L. Bryan Company, Legal Printers, Columbia, S. C.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

ADDENDUM

Internal Revenue Code of 1954 (26 U. S. C.):

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000.00, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.00.

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) General Rule.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * *

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) **Unreasonable Accumulation Determinative of Purpose.**—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) **Holding or Investment Company.**—The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of the purpose to avoid the income tax with respect to shareholders.

SEC. 801 [as amended by Sec. 2 (a), Life Insurance Company Income Tax Act of 1959, P. L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.

(a) **Life Insurance Company Defined.**—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C. F. R.):

§ 1,801-1 **Definitions.**

(a) **Life insurance company.** The term "life insurance company" as used in subtitle A of the Code is defined in section 801. For the purpose of determining whether a company is a "life insurance company" within the meaning of that term as used in section 801, it must first be determined whether the company is taxable as an insurance company under the Code. * * *

(b) **Insurance companies.** * * *

(2) Though its name, charter powers and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code. For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the

year 1954 within the meaning of the Code and the regulations thereunder.

In the case at Bar where the court is dealing with a local-domestic, intrastate Insurance Company by state statute 37-281, and we quote S. C. Code of Laws 37-381:

> "At the end of each three years of operation of every domestic insurance company the Commissioner shall personally, or by an examiner, visit each such company and thoroughly inspect and examine at least those affairs conducted during each full year of operation since the last such examination, especially as to its financial condition and ability to fulfill its obligations and whether it has complied with the laws. This examination shall be conducted at some time during the year immediately following the period of operation covered by the examination. . . ." § 37-281; 1947 (45) 322; 1948 (45) 1734; 1957 (50) 282; 1960 (51) 1646. Applied in *Calhoun Life Ins. Co. v. Gambrell*, 245 S. C. 406, 140 S. E. (2d) 774 (1965).

And we quote from *Calhoun Life Insurance Company v. Gambrell*, 140 S. E. (2d) 774, § 2:

> ". . . In General, these sections, in addition to providing certain specific financial requirements with respect to all companies, give to the Commission and the Chief Commissioner full power to take appropriate action against any particular company which may be operating in violation of law, or in an unsound financial condition, even to the extent of revoking the license of the same or putting it into receivership. . . ."

The Congress reversed the *Southeastern Underwriters* case by congressional legislation which is the latest chapter in the history of insurance regulation and is cited as the McCarran-Ferguson Act, 26 Fed. Code (1945) Anno. 15, USCA, Sec. 1011-1015, and we quote:

> "Sec. 1. Congress declares that the continued regulation and taxation by the several States of the

business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

"Sec. 2(a). The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

"Sec. 2(b). No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance or which imposes a fee or tax upon such business, unless such Act specifically related to the business of insurance . . ."

§ 1.801-3 **Definitions.**

For purposes of part I, subchapter L, chapter 1 of the Code, this section defines the following terms, which are to be used in determining if a taxpayer is a life insurance company (as defined in section 801 (a) and paragraph (b) of this section):

(a) **Insurance company.** (1) The term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

(2) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. For taxable years beginning before January 1, 1970, a voluntary unincorporated association of employees, including an association fulfilling the requirements of section 801 (b) (2) (B) (as in effect for such years), formed for the purpose of relieving sick and aged members and the dependents of de-

ceased members, is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not an insurance company, and the income from such fund shall be included in the return of the corporation.

(b) **Life insurance company.** (1) The term "life insurance company", as used in subtitle A of the Code, is defined in section 801 (a). For the purpose of determining whether a company is a "life insurance company" within the meaning of that term as used in section 801 (a), it must first be determined whether the company is taxable as an insurance company (as defined in paragraph (a) of this section). An insurance company shall be taxed as a life insurance company if it is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, and its life insurance reserves (as defined in section 801 (b) and § 1.801-4), plus unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in section 801 (c) and § 1.801-5). For purposes of determining whether it satisfies the percentage requirements of the preceding sentence, a company shall first make any adjustments to life insurance reserves and total reserves required by section 806 (a) (relating to adjustments for certain changes in reserves and assets) and then as required by section 801 (d) (relating to adjustments in reserves for policy loans). For examples of the adjustments required under section 806 (a), see paragraph (b) (4) of § 1.806-3. For an example of the adjustments required under section 801 (d), see paragraph (c) of § 1.801-6. Furthermore, if an insurance company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818 (c), such revalued basis shall be disregarded for purposes of section 801.

* * *

§ 537. Reasonable needs of the business.

(a) General rule.—For purposes of this part, the term "reasonable needs of the business" includes—

(1) the reasonably anticipated needs of the business.

* * *

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

* * *

ARTICLE 6.

Financial Matters (as it appeared in 1962)

§ 37-181. Capital and surplus required of stock companies.—Before licensing any stock insurance company to begin to transact business in this State the Commissioner shall require such company to be possessed of not less than one hundred thousand dollars capital, which must be maintained at all times, and one hundred thousand dollars surplus fully paid in. (1952 Code § 37-181; 1947 (45) 322; 1957 (50) 402.)

* * *

§ 37-183. Exceptions for companies qualified prior to May 12, 1947.—The provisions of §§ 37-181 and 37-182 are not intended to be retroactive or to apply to any company doing business in this State prior to May 12, 1947, if such company maintains the capital and surplus or surpluses it had on January 1, 1947. (1952 Code No. 37-183; 1947 (45) 322; 1948 (45) 1734.)

* * *

ARTICLE 6.

Financial Matters (as it appeared in 1971)

§ 37-181. Capital and unassigned surplus required of stock companies; when delinquent; action on delinquency. —(a) Before licensing any stock insurance company to transact business in this State, the Chief Insurance Commissioner shall require such company to be possessed of capital which must be maintained at all times, and unassigned surplus, twenty-five percent of which must be maintained at all times, in amounts not less than the following:

If Licensed to Write	Capital	Surplus
Life	$150,000	$150,000
Accident and health	150,000	150,000
Life, accident and health	300,000	300,000
Property	300,000	300,000
Casualty	300,000	300,000
Surety	300,000	300,000
Marine	300,000	300,000
Title	150,000	150,000
Multiple lines	375,000	375,000

(b) If at any time the unassigned surplus of a stock insurance company is less than twenty-five percent of the surplus initially required, as set forth in subsection (a) of this section, such company shall be deemed delinquent and delinquency proceedings may be commenced by the

Chief Insurance Commissioner as provided by Act No. 852 of 1962 [§§ 37-297 to 37-297.20].

(c) If at any time the capital of a stock insurance company is impaired to any extent, such company shall be delinquent and the Chief Insurance Commissioner shall commence delinquency proceedings. (1952 Code § 37-181; 1947 (45) 322; 1957 (50) 402; 1963 (53) 564; 1971 (57) 311.)

Effect of amendments.—The 1963 amendment increased the capital requirement for all companies except life, accident and health and title required unassigned surplus in the above amounts instead of a surplus of $100,000.00, and added provisions for maintenance of unassigned surplus and the last two paragraphs.

§ 37-183. Capital and surplus requirements of companies licensed May 15, 1971; when delinquent; action on delinquency.—The provisions of §§ 37-181 and 37-182 shall not apply to any company that is licensed to do business in this State on May 15, 1971, if such company continues to remain licensed in this State and continues to maintain at least the following minimum capital and surplus amounts, if a stock company, or minimum surplus, if a mutual company;

(a) Any domestic or foreign stock company, if possessed of capital and surplus amounts on December 31, 1970, that were in compliance with the law at that time, but which are less than the minimums required to be maintained by § 37-181, must maintain not less than the amount of capital stated in its 1970 annual statement filed with the Chief Insurance Commissioner pursuant to § 37-293, and in addition must maintain an unassigned surplus of not less than twenty-five percent of such amount of capital. If at any time the unassigned surplus of such company shall be reduced to an amount that is less than twenty-five percent of such minimum amount of required capital, such company shall be deemed delinquent and delinquency proceedings may be commenced by the Chief Insurance Commissioner as provided by §§ 37-297 to 37-297.20. If at any time the minimum capital required to be maintained by this section by such company should become impaired to any extent, such company shall be delinquent and the Chief Insurance Commissioner shall commence delinquency proceedings. If at any time the capital should be increased to an amount greater than the amount possessed at December 31, 1970, the amount of unassigned surplus that must be maintained thereafter shall be twenty-five percent of such greater amount of capital, and if such amount is not maintained, delinquency proceedings may be commenced by the Chief Insurance Commissioner as provided by §§ 37-297 to 37-297.20. Such increased amount of capital shall not thereafter be reduced to an amount less than the amount required by § 37-181 and if it should be reduced or should become impaired to any extent, such company shall be delinquent and the Chief Insurance Commissioner shall commence delinquency proceedings.

(b) Any domestic or foreign mutual company, if possessed of unassigned surplus on December 31, 1970, that was in compliance with the law at that time but is less than the minimum required to be maintained by § 37-182, must maintain not less than the amount of unassigned surplus stated in its 1970 annual statement filed with the Chief Insurance Commissioner pursuant to § 37-293. If at any time the surplus of such company should be reduced to an amount that is less than eighty percent of the amount shown in its 1970 annual statement, such company shall be deemed delinquent and delinquency proceedings may be commenced by the Chief Insurance Commissioner as provided by §§ 37-297 to 37-297.20. If at any time the surplus of such company should be increased to an amount greater than the amount possessed at December 31, 1970, eight

percent of such greater amount of unassigned surplus, or the minimum amount required to be maintained by § 37-182, whichever amount is the lesser, must be maintained thereafter, and if it is not so maintained, such company shall be deemed delinquent and delinquency proceedings may be commenced by the Chief Insurance Commissioner as provided by §§ 37-297 to 37-297.20. (1952 Code § 37-183; 1947 (45) 322; 1948 (45) 1734; 1963 (53) 564; 1971 (57) 311).

Effect of amendments.—Prior to the 1963 amendment, the section provided only that it and § 37-182 were not retroactive nor intended to apply to any company doing business prior to May 12, 1947, if such company maintained the capital and surplus it had on January 1, 1947. The 1963 act also added what are codified herein as §§ 37-183 to 37-183.3.

The 1971 amendment changed the date in the first paragraph from June 14, 1963 to May 15, 1971 and changed the dates in subdivisions (a) and (b) from 1962 to 1970.

§ 37-183.1. Same; notify companies of amounts required; publish schedule annually.—Following verification by the Chief Insurance Commissioner of the accuracy of all annual statements filed for the year 1962 by all insurance companies licensed to do business in the State on June 14, 1963, the Chief Insurance Commissioner shall notify each licensed company that does not comply with § 37-181 or § 38-182 of the amounts of capital and surplus if a stock company, or the amount of surplus, if a mutual company, such company must maintain in order to continue to remain licensed in this State. A schedule of such amounts required to be maintained by each company so notified shall be published annually in all succeeding annual reports of the Insurance Commission that the Chief Insurance Commissioner shall submit to the General Assembly

through the Governor, as required by § 37-57. Such schedule shall be revised annually as to those companies whose minimum capital and surplus requirements shall be increased periodically as required by § 37-183. (1963 (53) 564).

Cross reference.—See note to § 37-183.

§ 37-183.2. **Same; kinds of insurance companies write.**—Any company that fails to meet the minimum capital and surplus requirements of § 37-181, if a stock company, or § 37-182, if a mutual company, but which continues to remain licensed by virtue of the provisions of § 37-183, must confine its business to the kinds of insurance for which it was licensed on December 31, 1962. If at any time any such company desired to write additional kinds of insurance, it must comply with the capital and surplus requirements of § 37-181 or § 37-182, as applicable. (1963 (53) 564).

* * *

A BILL

To Amend Section 37-183, Code of Laws of South Carolina, 1962, as Amended, Relating to Capital and Surplus Requirements of Insurance Companies, so as to Reenact Certain Subsections Inadvertently Deleted in a Previous Amendment to the Section and to Require Them to Meet Such Requirements by April 1, 1976, if They are to Remain Licensed to do Business in This State, and Sections 37-1405, 37-1406 and 37-1423, Relating Respectively to the Filing of Certain Statements Concerning the Acquisition of Insurance Companies, the Information Required in Such Statements, and the Surplus Requirements of Insurance Companies, so as to Correct Certain Code Section References.

Be it enacted by the General Assembly of the State of South Carolina:

SECTION 1. Section 37-193 of the 1962 Code, as last amended by Act 274 of 1971, is further amended by adding the following at the end of the section:

"(c) Any company that fails to meet the minimum capital and surplus requirements of Section 37-181, if a stock company, or Section 37-182, if a mutual company, but which continues to remain licensed by virtue of the provisions of this section, must confine its business to the kinds of insurance for which it was licensed on December 31, 1970. If at any time any such company desires to write additional kinds of insurance, it must comply with the capital and surplus requirements of Section 37-181 or Section 37-182, as applicable.

(d) Following verification by the Chief Insurance Commissioner of the accuracy of all annual statements filed for the year 1970 by all insurance companies licensed to do business in the State on May 15, 1971, the Chief Insurance Commissioner shall notify each licensed company that does not comply with Section 37-181 or Section 37-182 of the amounts of capital and surplus, if a stock company, or the amount of surplus, if a mutual company, such company must maintain in order to continue to remain licensed in this State. A schedule of such amounts required to be maintained by each company so notified shall be published annually in all succeeding annual reports of the Insurance Commission that the Chief Insurance Commissioner shall submit to the General Assembly through the Governor, as required by Section 37-57. Such schedule shall be revised annually as to those companies whose minimum capital and surplus requirements shall be increased periodically as required by this section.

(e) This section shall not be construed as a limitation of any authority conferred elsewhere by this Title upon the Chief Insurance Commissioner to deny a license to, or to revoke or suspend the license of, any company applying for a license or licensed to do business in this State.

(f) The provisions of this section shall not apply to any insurance company described herein after April 1, 1976, and no such insurance company shall thereafter remain licensed to do business in this State unless it meets the minimum requirements of Section 37-181 or Section 37-182."

* * *

QUESTIONS PRESENTED

This action was brought by Industrial Life Insurance Company (hereinafter referred to as taxpayer) pursuant to the provisions of 28 U. S. C. A. 1346 for the refund of income taxes and interest on the amount of $41,037.35 assessed against the taxpayer as additional tax and interest for the years 1963, 1964, and 1965. (App., p. 168.) Taxpayer had previously paid the additional assessment under protest and had filed a claim for refund, which was denied. Taxpayer brought this action subsequent to the denial of its claim for refund. The case was heard by the District Court and on April 12, 1972 the Court filed its findings of fact and conclusions of law and ordered that the taxpayer's action for refund of income taxes and interests be dismissed with costs. (App., p. 168.) The taxpayer filed a timely appeal to the Fourth Circuit Court, and on July 3rd, 1973, the court upheld the District Court and the taxpayer filed a timely petition for a review, the same was denied on July 23rd, 1973, and this petition for a writ of Cert. is filed in a timely and proper manner. Jurisdiction is conferred upon this Court by 28 U. S. C. § 1291.

All of the factual setting of this case is undisputed; which is necessary for this decision.

The taxpayer was chartered as an insurance company on April 19, 1939, by the Secretary of State for South Carolina under the name of General Insurance Corporation, and through various name changes and amendments to the charter became Industrial Life Insurance Company on September 25, 1956. (App., p. 122-A.) The original authorized capital stock of the taxpayer corporation was $10,000.00, of which $2,500.00 was paid in capital. (App., p. ...)

Taxpayer's charter empowers it; "to issue contracts of insurance against all manner of hazards, including sickness, accident, death, casualty and liability, and all other forms of insurance contracts; to buy, sell, mortgage, and lease real estate and to do all things necessary and incident to the above powers. (App., p. 122-A.)"

And we quote from the Charter itself which was granted by South Carolina Legislative Authority regulating the insurance business in South Carolina and therefore subject to Sec. 2(b) of the McCarran Ferguson Act:

> McCarran Ferguson Act: Sec. 2(b) "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance ..."
>
> Charter: "To issue contracts of insurance against all hazards, including sickness, death, casualty and liability, and all other forms of insurance contracts; to buy, sell, mortgage, and lease real estate and to do all things necessary and incident to the above powers."

During 1942, control of the taxpayer corporation was acquired by Clayton Seyphers and his immediate family, who now own all the corporation stock, constitute its Board of Directors and serve as its officers. (App., p. 138.)

During every year of its existence, the taxpayer corporation has filed its annual statement of business with the Insurance Department of the State of South Carolina. As a result of the filing of such annual statements, the South Carolina Insurance Commission, the S. C. official regulatory agent, has treated the taxpayer as a life insurance company in every year since 1939 and has issued a license to do a statewide life and accident and health insurance business to the taxpayer for each year since 1939. (App., 129.)

During its early years, taxpayer was predominately engaged in the sale of industrial life, accident and health insurance policies, with the premiums for such insurance being collected mostly on a weekly basis, at policyholders' door. (App., p. 144.) This business was reinsured by the taxpayer through reinsurance agreements in 1946 and 1953 with Dixie Life Insurance Company and First National Insurance Company respectively. (App., p. 155.) Pursuant to the reinsurance agreements, the reinsurance companies serviced the policies involved, but taxpayer remained liable on the policies by law because there was no release by the policyholders or no novation, and on occasion, has had to make payments as a result of its liability. (App., p. 142.) Since 1956 taxpayer's insurance business has, principally consisted of credit life insurance policies, issued on mortgages and bank loans. During 1963, 1964 and 1965, the years of the deficiency income tax assessments, the taxpayer's insurance business mainly consisted of a group credit life policy on the lives of the debtors of Consumer Investment Company, Inc., providing continuous life insurance coverage on the lives of 1,000 to 1,200 debtors of the company living all over S. C. (App., p. 125.) In addition to the credit life insurance, taxpayer issued key man life insurance policies on the lives of Clayton Seyphers, his wife and son during the years 1963, 1964 and 1965, and during

1963 and 1964 the taxpayer sold several industrial life policies to members of the Scyphers family.

Taxpayer's financial summary for the tax years in question appears on the following pages as prepared by the S. C. Insurance Commission which were its official S. C. judgments pursuant to authority granted by the Congress in the McCarran-Ferguson Act and by the South Carolina legislature on this strictly intrastate insurance business.

SUMMARY OF QUESTIONS INVOLVED

In 1921, during the reign of *Paul v. Virginia* (1869-1944), the Congress passed what is now Section 801 defining what is a life insurance company for federal tax purposes. The essence of which is that if the taxpayer had more than 50% of its reserves in life reserves it is a life insurance company for federal tax purposes. In 1942, the Congress slightly amended Section 801 and allowed the taxpayers to calculate noncancellable health and accident policies reserves as life reserves but did not amend the 50% test nor has this 50% life reserve test been amended even until today. It is not disputed that the taxpayer had more than the 50% life reserve test, so it meets the statute. In 1944, the Supreme Court of the U. S. decided *U. S. v. Southeastern Underwriters* case, 88 L. Ed. 1440 (1944) which reversed *Paul v. Virginia* and held under certain conditions that insurance could be interstate commerce. The Congress, the lawyers, the judges, the insurance operators were greatly alarmed over the Southeastern Underwriters decision, and in 1945, the Congress passed the McCarran Ferguson Act cited as 15 U. S. C. A. 1011-1015 the essence of which was to reinstate the state's absolute uncontradicted power and management of the insurance industry as had been under *Paul v. Virginia*. The State of South Carolina, pursuant to Section 801 defining a life insurance company and Sec. 2(b) of the McCarran Act has passed final judgment on the question involved in this case, and if the Congress has the power to make the laws, then the courts do not have the power to manage and regulate insurance business as they have done in this case. Therefore, a simple application of the undisputed evidence to Section 801 defining a life insurance company and the McCarran Ferguson Act, the taxpayer thinks justifies a simple verdict for the taxpayer.

In 1948, taxpayer bought 504 acres of land in Kershaw County, South Carolina as an investment. (App., 172(14).) In the mid-1950's taxpayer made a decision to dispose of the real estate in order to capitalize on the investment. After being unsuccessful in an effort to sell the land in one tract as a whole at what is deemed a reasonable price, taxpayer subdivided some of the land and disposed of it in lots. (App., p. 172.) During 1963 the taxpayer by three deeds conveyed eleven lots from the tract to Clayton Seyphers and in 1964 taxpayer in one deed conveyed eleven more lots from the tract to Clayton Seyphers. (App., p. 121.) Prior to beginning the sale of any of the lots from the tract, taxpayer obtained permission from the South Carolina Insurance Commission (App., p. 172, Sec. 15) the S. C. Regulatory Agency who approved the sale by Sec. 2(b) of the McCarran Act.

During the tax years in question no dividends were paid by the taxpayer corporation; earnings and profits for the years in question have been accumulated and the unassigned surplus account at the end of each of the years was $232,765.41 for 1963, $260,018.06 for 1964 and $269,099.38 for 1965. (App., p. 124.) Taxpayer operated under a "grandfather clause" exemption from the provisions of South Carolina State Law (§ 37-181, South Carolina Code of Laws, 1962). (Add., p. 1), which require a minimal initial capital and surplus of $600,000.00 for new insurance companies. (Add., p. 5.)

The Courts found that during 1963, 1964 and 1965:

(1) Taxpayer was not an insurance company within the meaning of Section 801(a) of the Internal Revenue Code of 1954 and therefore did not qualify for tax treatment accorded life insurance companies thereunder. (App., p. 66);

(2) Taxpayer had accumulated its earnings beyond the reasonable needs of its business and was therefore subject to the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code of 1954.

(3) Taxpayer was engaged in the sale of lots in the ordinary course of its trade or business.

Taxpayer's Note: (Which was beyond its Charter powers and if this was true, it was the S. C. Regulatory agency's duty to stop it, but instead it approved. Because it had given authority for same.) So, the proceeds therefrom should have been taxable at ordinary insurance income rates, incidental to the insurance business by Sec. 2(b) of the McCarran Act.

This appeal followed.

STATEMENT OF THE CASE AND ARGUMENT

In 1921, the Congress of the United States promulgated and passed what is now Sec. 801 of the Federal Code which defines and classified what is a life insurance company under the Federal law for Federal tax purposes. The essence of which was that if the reserves as held by the life insurance company consisted of more than 50% life reserves (not health and accident) it was considered a life insurance company under the Federal law. In 1869, the Supreme Court of the United States decided the case of *Paul v. Virginia,* 19 L. Ed. 168 (1869) and the essence of this decision was that insurance was not interstate commerce; therefore, under the Federal Commerce Clause, the business was not subject to Federal regulation and hence state regulation took over. This remained the law until 1944 when the Supreme Court of the United States decided the now famous case of *U. S. v. Southeastern Underwriters,* 80 L. Ed. 1440 (1944) which case was based wholly and only on facts creating interstate commerce and in fact not creating intrastate commerce such as the local domestic intrastate taxpayer.

The important fact is that the Congress had one test and one alone; namely, the more than 50% life reserve test; no more or no less. Undoubtedly, the reason was that in 1921, the year that this statute was passed, Congress was operating under the reign of *Paul v. Virginia,* 19 L. Ed. 168 (1869) and under *Paul v. Virginia,* the states had absolute complete regulation and management of the insurance business because insurance under *Paul v. Virginia* was not interstate commerce. So, if this taxpayer had more than 50% life reserves, it meets the definition of Section 801 and that is all there is to it. The taxpayer's position is that none other than Congress itself had the power to amend the more than 50% life reserve test. This test the taxpayer met, and we say the taxpayer should prevail.

We quote from two of the factual statements in *Southeastern Underwriters* which bears out the fact that were it not for the interstate facets, the decision would not have been what it was, and we quote from the interstate facts:

> ". . . A large share of the insurance business is concentrated in a comparatively few companies located, for the most part, in the financial centers of the East. Premiums collected from policyholders in every part of the United States flow into these companies for investment. As policies become payable, checks and drafts flow back to the many states where the policyholders reside . . .

> "The modern insurance business holds a commanding position in the trade of our nation . . . Its total assets as of 1944 exceeds $6,000,000,000. . . . Its labor force of 524,000. . . . Insurance touches the home, the family, and the occupation or the business of almost every person in the United States."

Then the Congress reversed the *Southeastern Underwriters* case by congressional legislation which is the latest chapter in the history of insurance regulation and is cited as the McCarran-Ferguson Act, 26 Fed. Code (1945) Anno. 15, USCA, Sec. 1011-1015, and we quote:

> "Sec. 1. Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.
>
> "Sec. 2(a). The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.
>
> "Sec. 2(b). No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance or which imposes a fee or tax upon such business, unless such Act Specifically relates to the business of insurance . . ."

Taxpayer's Note: The term to regulate has been before the courts many times, and we cite the two following cases as typical; in *Southern R. Co. v. Russell,* 112 S. E. 700, 703, 133 Va. 292, the court said:

> "To 'regulate' is to fix or control the manner in which a thing is to be done; to prescribe a rule or method for doing it. It is comprehensive enough to cover the exercise of authority over the whole subject to be regulated."

The Supreme Court of the U. S. defined the word regulate in the case of *St. Louis v. Western Union Telegraph Co.*, 149 U. S. 465, 469, 37 L. Ed. 810 as follows:

> "The word 'regulate' is one of broad import. It is the word used in the federal Constitution to define the power of Congress over foreign and interstate commerce, and he who reads the many opinions of this court will perceive how broad and comprehensive it has been held to be."

One of the confusing things in the courts below was that the courts made a statement similar to this in that the Congress did not turn over to the states Congress' following the *Southeastern Underwriters* case the Congress power to tax. Of course, this is true. On the other hand, did not change or enlarge Section 801 of the Federal Code in regard to the 50% reserve rule, but completely reinstated the states absolute power of regulation and management of the insurance industry in their state by reason of the McCarran-Ferguson Act, but Section 801 still says if the taxpayer has more than 50% life reserves it is a life insurance company for Federal tax purposes because these are the words of the statute.

This cause came on to be heard in the District Court of South Carolina by the Honorable Robert Chapman. The purpose of this suit was to seek a refund of taxes paid under protest. The taxpayer contends that it was a life insurance company under the Federal Code definition of Section 801. The Internal Revenue Service contended that it did not meet the terms of the definition of a life insurance company under Section 801. The definition was promulgated by the Congress in 1921, and the essence of which was that if the taxpayer's total reserves were more than 50% life reserves, then it met the terms of Section 801, no more and no less. It is interesting to note that the facts in this case that are pertinent to this decision are not in dispute, but it is a case of applying the statute and case law to the undisputed facts.

In the beginning, we must point out that there is a serious difference of opinion among the circuits as to whether or not the Federal government has a right to substitute Federal Regulation 1.801-3(a)(1) for Section 801, the statute itself, which Statute and Federal Regulation are contradictory to each other.

The case of *Lamano-Panno-Fallo,* 127 F. (2d) 58 (1942) (5th CC) held that the Internal Revenue Service is bound by the statute and not by a regulation which changes the words, intent and spirit of the statute.

We quote from *Lamano-Panno-Fallo,* 127 F. (2d) p. 58 (1942) (Fifth Circuit):

> "He (the Commissioner) is also concerned to examine the reserves under Section 201 to be sure the taxpayer is a life insurance company at all, for that Section defines a life insurance company as one whose reserves held for the fulfillment of its life insurance and annuity contracts comprise more than fifty per centum of its total reserve funds." 127 F. Rep. (2d), p. 58, Syllabus (1-4) (1942). Here the court used Section 201 (now 801) and not Regulations 1.801-3(a) which decision was followed by Alinco in 1967.
>
> "We are of opinion that the Revenue Act, and Regulation 94 construing it, do not concern themselves with the sufficiency, but only with the character" of the reserves of insurance companies. It is not the function of the commissioner to review the decision of the state insurance department as to the sufficiency of the reserves or the solvency of the company." Which Alinco later confirmed and see the intent of Congress by the words of Mr. Wilbur Mills from the debates in Congress, February 18, 1959, 105 Congressional Record, pp. 2576-2577."

Now we quote from the most important lower court cases of our time, reflecting the 1942 Amendment of Section 801, showing the addition of noncancellable health and accident insurance—*Alinco v. U. S.,* 373 F. (2d) 336 (1967). In the beginning of this quotation, the Court of Claims made clear when it said:

> "Taxation is peculiarly a matter of statutory law, and in applying the law to the determination and computation of income and deductions, the Court does not make moral judgments . . ."

Again the Court made this very important observation:

> "It is not a matter of conscience but of statute and a determination of congressional intent. The Government's presentation of its case against Alinco has been flavored with moral and regulatory overtones. Such a sensitive concern for good business morals should not be for the Treasury . . ."
>
> "Alinco asked only that it be taxed like other life insurance companies. In my judgment it is entitled to be so taxed provided only that it can meet the technical statutory requirements set forth as such in 801 of the Code. Since life insurance companies were taxed differently from casualty companies, it became necessary to find what constituted a life insurance company and the following definition was adopted in Section 242 of the Act. When used in this title the term life insurance means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health and accident insurance) the reserve funds of which held for the fulfillment of such contracts comprise more than fifty per centum (50%) of its total reserve funds . . . thus it was the character of an insurance company's business as measured by its policy reserves that served as the touchstone for the definition of 'life insurance company'."

Then the District Court proceeded to define or quote Sec. 801 of the Federal Code, which our two cases just quoted support word for word Sec. 801 of the Federal Code.

In Section 801 (a) life insurance companies are defined:

> "For purposes of this subtitle, the term 'life insurance company' means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b), plus
>
> (2) unearned permiums, and unpaid losses (whether or not ascertained), or noncancellable life, health or accident policies not included in the life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c)."

It is also interesting to note that when this case was under consideration in Columbia, S. C., that there was a case in West Memphis, Arkansas, cited as *Drummonds-Citizens Insurance Company,* and there the insurance company took the position that the statute as promulgated by the Congress classified as Section 801, did not control the situation but instead Federal Regulation 1.801-3(a) (1) did control, the then Assistant Attorney General in charge of taxes, Mr. Johnnie Walters, later Commissioner of the Internal Revenue, in his brief in the *Arkansas* case took the exact position that taxpayer is taking in this case, and we quote the brief of Mr. Walters:

Government's Brief in the *Drummonds Citizens Insurance Company Case of Arkansas* (1969) which was going on the same time this taxpayer's case was and the government, in their brief in that case, took the same position that this taxpayer takes, and this brief was signed by Mr. Johnnie Walters, who was then the Chief Tax Counsel for the United States and he personally signed this brief in 1969, and we quote:

> "Rather the statutory language is explicit in providing that, for purposes of federal income taxes, the term 'life insurance company' means a company which sells life insurance if its reserves meet certain prescribed requirements." (Our Note—meaning Section 801.)

And on page 13 and 14 of that same Government Brief, we quote again:

> "In 1942, the statute was changed so that only reserves which qualified for the computational sections could also be considered as life insurance reserves for the preliminary purpose of qualifying the company as a life insurance company. See Section 163 of the Revenue Act of 1942, c. 619, 56 Stat. 798. That statutory scheme has been carried forward to the 1954 Code."

According to Mr. Walters' brief, the 1942 amended statute did away with Federal Regulation 1.801-3(a)(1) as a preliminary test of what is an insurance company. But the government is taking a different position in this case at bar.

> "Thus, Congress has deliberately provided that it is the company's reserves (and not its business, as taxpayer contends) which determine whether the company is a life insurance company for federal income tax purposes. Hence, it was necessary in *Alinco Life Insurance Company v. United States*, 373 F. (2d) 336 (dt. Cl., 1967), for the Court to analyze Alinco's reserves to determine whether it would qualify as a life insurance company within the terms of Section 801 (a) of the Code in spite of the fact that Alinco's sole business activity was the reinsurance of life insurance policies. If taxpayer's position herein were correct, Alinco would have qualified automatically regardless of its reserves."

But the District Court in this case held it was the company's business and not its reserves, as Code Section 801 provides; otherwise the taxpayer would have prevailed.

And in another part of the *Alinco* decision it said:

> ". . . (thus it was the character of an insurance company's business as measured by its policy reserves that served as the touchstone for the definition of 'life insurance company'.")

So, there can be no question but that the Statute, Section 801 of the Federal Code, defining a life insurance company as passed by the Congress controls this case; and that the sole test according to Section 801 of the Act of the Congress is the more than 50% life reserve test, with no minimum amount and no maximum amount and there is no other test. Nor, can anyone except the Congress itself change this Statute.

Now we quote from the District Judge's Opinion which was approved by the Fourth Circuit Court of Appeals, and which both opinions refused to abide by Section 801 as the *Lamano-Panno-Fallo* case and *Alinco* and the brief of the Government in the *Drummonds-Citizens Insurance Company* case of West Memphis, Ark., did all hold contrary to the holding of the District Court in this case, yet the Fourth Circuit Court of Appeals approved.

Now we quote from the District Court's Opinion in the case now at bar:

> "Before a company may be classified under the above section as a life insurance company, it is necessary to determine if it is an insurance company, since, this is the first requirement mentioned. The Internal Revenue Code does not define the term 'insurance company,' but Treasury Regulations on Income Tax (1954 Code), Section 1.801.3(a) provides:
>
> > "(1) The term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issu-

> ing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State Insurance laws are significant in determining the business which a company is authorized and intends to carry on. It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code."
>
> "Section 1.801-3(2) (b) Life Insurance Company. (1) The terms 'life insurance company' as used in subtitle A of the Code, is defined in Section 801 (a). For the purpose of determining whether a company is a 'life insurance company' within the meaning of that term as used in Section 801 (a), it must first be determined whether the company is taxable as an insurance company (as defined in paragraph (a) of this section). . . ."
>
> 'Treasury Regulations have the force and effect of law and provide a standard to be followed in determining plaintiff's classification'."

May we point out and stress with great emphasis that the District Court reversed the most important case of our time; namely, *Alinco Life Insurance Company*, and we quote from *Alinco* where the case at bar reversed *Alinco, Lamano-Panno-Fallo* and the *Drummonds-Citizens* case, leaving the insurance industry in a state of turmoil and confusion because of the diversity of opinion in the lower courts as to what it takes to be a life insurance company under Federal Statute Section 801 defining a life insurance company. Now we quote *Alinco:*

> ". . . The principal question, therefore, is not whether Alinco was an **insurance company** but whether it was a life insurance company under the technical qualification formula, contained in Section 801."

Because the taxpayer was charged in this case of violating Section 801 and not Regulation 1.801-3(a)(1) which is in conflict with the Statute. See letter from Washington IRS dated June 30, 1970, to Columbia IRS, and we quote:

> "The issue presented is whether the taxpayer is a life insurance company within the meaning of section 801(a) of the Code for the taxable years under examination.
>
> **Section 801(a) of the Code provides in part and in substance that for purposes of Subtitle A of the Code, a life insurance company is an insurance company which is engaged in the business of issuing life insurance and annuity contracts if—(1) its life insurance reserves . . . comprise more than 50 percent of its total reserves. . . "**

In the 1,800 reinsured policies still on the books for the three tax years, we say we still have a contingent liability; we say in law that this cannot be questioned by anyone. All these policies met the State of South Carolina's life reserve test, but we call the court's attention that some 800 of these 1,800 weekly premium policies were A. & H. non-cancellable policies and these policies' reserves all met the life reserve test by S. C. law, but under the Federal law, no reserves are required to be a life insurance company under the Federal law on A. & H. weekly premium non-cancellable policies. Apparently, the one exception to the 50% rule. So, since this litigation involved Section 801 of the Federal Code and not the State law, undoubtedly these some 800 policies standing alone as such should require this court to hold with the taxpayer, since Code Section 801 requires no reserves as to these 800 policies under the following Code Section. Here the government can have no answer.

Section 801(b)(2)(a), and we quote:

> "Reserves Must Be Required by Law.—Except—(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on

> the weekly premium payment plan, continuing for life and not subject to cancellation. * * *"

The effect of which is this: That a company can be a huge life insurance company writing weekly premium A. & H. non-cancellable policies and still be a life insurance company under the Federal law because Section 801 bases its only test on reserves, and under the Federal law in this case, approximately 800 of these policies were still on the taxpayer's risks, and no reserves are required by Federal law, and the fact that they have been collected by the subcontractor since 1947, and since 1953 is of no consequence. See Van Schaick, 32 B. T. A. 736 (1935).

In addition to the testimony of Mr. Gilford Trapp, Mr. Donald Perkins, Mr. John A. Mills, and Mr. Reynolds, see record transcript, p. 26, last question and answer where the master group credit life policy dated March 1, 1962, was introduced and was the same contract that Mr. Gilford Trapp testified about.

Therefore, in fact and in truth the Government, basically and fundamentally is attacking the famous separation of powers in our form of government (which is contrary to President Nixon's position for himself as head of the Executive Department in the Watergate Matter) in that they do not want the Congress to lay and collect taxes as the Constitution provides, but seek to have the Secretary of the Treasury which is a branch of the Executive Department (not the Congress) to not only lay and collect taxes by Federal Regulation 1.801-3(a) but the District Court held that the regulation, even though it was contrary to the words, intent, and spirit of the Congress in Sec. 801 defining a life insurance company which should supersede and must be considered first instead of the more than 50% life reserve test, therefore rendering Sec. 801 of the Federal Code null and void. Therefore, if the Secretary of Treasury can do away with Sec. 801 of the act of the Congress, the people have lost their constitutional rights to have the elected members of the congress, to lay and collect their taxes as provided for in the Article 1, Sec. 8 of the Federal Constitution.

In 1944, the Supreme Court, in the case of *U. S. v. Southeastern Underwriters,* cited as 88 L. Ed. 1440 (1944), reversed *Paul v. Virginia.* As a result of the *U. S. v. Southeastern Underwriters* case, the insurance world, lawyers, judges, and insurance operations were put in turmoil and as a result of this turmoil Congress passed, in 1945, in what is known as the McCarran-Ferguson Act, which for all practical purposes reinstated the regulation and management of the insurance industry in the hands of the various states under the reign of *Paul v. Virginia,* because the insurance world was afraid of Federal Regulation, which is exactly what the case at bar holds we now have and which the McCarran-Ferguson Act was passed by the Congress to prevent Federal Regulation, and is cited as 15 U. S. C. A., Section 10-11-1015.

Here we cite the three important sections involving this case so far as the McCarran-Ferguson Act is concerned:

> "Sec. 1. Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.
>
> "Sec. 2(a). The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.
>
> "(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance or which imposes a fee or tax upon such

> business, unless such Act specifically relates to the business of insurance . . ."

One of the real questions before this court is did South Carolina regulate this taxpayer, and if so, did such regulation become binding on the federal court and remove its jurisdiction so far as regulation and management was concerned by reason of the above three quoted McCarran-Ferguson Act statutes, which gave South Carolina's Regulatory Agency exclusive regulatory and managerial powers, if the English language means anything.

In the case at bar where the court is dealing with a local, domestic, intrastate insurance company by S. C. state statute 37-281, and we quote S. C. Code of Laws 37-281 as to state regulation:

> "At the end of each three years of operation of every domestic insurance company the Commissioner shall personally, or by an examiner, visit each such company and thoroughly inspect and examine at least those affairs conducted during each full year of operation since the last such examination, especially as to its financial condition and ability to fulfill its obligations and whether it has complied with the laws. This examination shall be conducted at some time during the year immediately following the period of operation covered by the examination. . . ." § 37-281; 1947 (45) 322; 1948 (45) 1734; 1957 (50) 282; 1960 (51) 1646. Applied in *Calhoun Life Ins. Co. v. Gambrell*, 245 S. C. 406, 140 S. E. (2d) 774 (1965).

And we quote from *Calhoun Life Insurance Company v. Gambrell*, 140 S. E. (2d) 774, § 2:

> ". . . In General, these sections, in addition to providing certain specific financial requirements with respect to all companies, give to the Commission and the Chief Commissioner full power to take appropriate action against any particular company which may be operating in violation of law, or in an unsound

> financial condition, even to the extent of revoking the license of the same or putting it into receivership. . . ."

In fact, the lawyers, judges, and the insurance industry were afraid of federal regulation because up until 1944, the date of *Southeastern Underwriters* case, they had been regulated and managed by the state regulatory agencies under *Paul v. Virginia.* In light of the three sections heretofore quoted of the McCarran-Ferguson Act giving the State absolute regulatory and managerial power, the Congress, in the McCarran-Ferguson Act, made sure that the states would continue to manage and regulate the insurance industry, but in this case, the court overruled the state regulatory judgments, so now here we have federal regulation which the Congress provided we would not have, and we quote now from *Alinco v. U. S.,* 373 F. (2d) 336 (1967), the leading decision of the lower courts as to what is a life insurance company under federal law.

And, we quote again from Alinco: (as to State control and regulation and not Federal)

> **". . . Furthermore, Congress had made clear its desire that the insurance industry shall not be regulated by the Federal Government but the several states, P. L. 15, 79th Cong. 59 Stat. 33 (1945), as amended, 15 U. S. C. SS1011-1015, Pa. L. Rev. 199 ('58)" citing the McCarran-Ferguson Act for authority.**

Again we quote from *Alinco* as to State law and not Federal law controlling the insurance industry within the state's boundaries.

> **". . . Insofar as a state regulatory function is concerned, this court has specifically held that the Internal Revenue Service may not employ the Federal tax laws in an effort to enforce its own concept of what state law should or should not be."**

Now we turn from the statute itself to the intent of the Congress, and again we quote from *Alinco*:

> **"Taxation is peculiarly a matter of statutory law, and in applying that law to the determination and computation of income and deductions, the Court does not make moral judgments . . ."**

In 1959, the Congress was re-writing the tax law for insurance companies and we quote from the debates in the House by Chairman Mr. Wilbur Mills, Congressman Simpson, and Senator McCarran: (Feb. 18, 1959, Vol. 105 Cong. Rec. 1. 2576-2577)

> **". . . We are trying to preserve as best we can in this bill the management of this industry in the hands of the state regulatory agencies and not to change in any way the situation so as to turn over to the Commissioner of Internal Revenue, the Secretary of the Treasury, or anyone else in Washington the regulatory authority . . ."**

During the same debates and on the same pages of the Congressional Record, Congressman Simpson had this to say which verifies and supports the words of Chairman Congressman Wilbur Mills of the Ways and Means Committee: Now we quote Mr. Simpson as to the all important reserves, the sole test in Section 801 of what is a life insurance company under federal law.

> **". . . That the committee had no intention of placing jurisdiction of the management of insurance company reserves within the hands or powers of the Commissioner of Internal Revenue . . ."**

When the legislation got across to the Senate side, then Senator McCarran, the author of the Bill, told the Senate that the Bill did not really change the law of *Paul v. Virginia*, where the States had complete management and control of the insurance industry and we quote the words of Senator McCarran:

> "In other words, we give to the states no more powers than those they previously had, and we take none from them." 91 Congressional Record 1442.

In the *Wilburn Boat Company v. Fireman Insurance Company*, 348 U. S. 310, in a dispute over a regulation of an insurance policy on a boat that burned up on a lake between Texas and Oklahoma, the Court said the power of the State in *Paul v. Virginia* or prior to *Southeastern Underwriters* case used these words:

> ". . . This constitutional doctrine carrying implications of exclusive state power to regulate all types of insurance contracts remained until 1944 when this court decided *United States v. South-Eastern Underwriters Assn.*, 322 U. S. 533 . . ."

And in this decision the court made many far reaching observations having references to the McCarran-Ferguson Act, and we make reference to this important case.

So, it becomes extremely important for this court to analyze the actions of the South Carolina Insurance Department where by reason of the authority granted to them by state statute 37-281, which State Statute was interpreted by the Supreme Court of South Carolina in the case of *Calhoun Life Insurance Company v. Gambrell*, 140 S. E. (2d) 77. In light of the three sections heretofore quoted of the McCarran-Ferguson Act giving the State absolute regulatory and managerial power, and in light of the Supreme Court of the United States, particularly in the case of *F. T. C. v. Travellers Health Association*, 362 U. S. 297, where the Supreme Court was reviewing what it had held in the case of *F. T. C. v. National Casualty Company*, 357 U. S. 560, where the court interpreted its holding in the *National Casualty Company* and we quote:

> ". . . In these circumstances the Court found there was 'no question but that the States possess ample means to regulate this advertising within their respective boundaries.' 357 U. S., at 564. It was held that § 2 (b) of the McCarran-Ferguson Act 'withdrew from the Federal Trade Commission the authority to regulate respondents' advertising practices in those States which are regulating those practices under their own laws.' 357 U. S., at 563. The Court expressed no view as to 'the intent of Congress with regard to interstate insurance practices which the State cannot for constitutional reasons regulate effectively . . .' 357 U. S., at 564."

In a dissenting opinion when the court refused to let Nebraska regulate the insurance business in other states for constitutional reasons, we quote from Judge Harlan's dissenting opinion where he quoted from *Prudential Insurance Company v. Benjamin*, 328 U. S. 408 at pp. 429 and 430:

> "Obviously Congress' purpose was broadly to give support to the existing and future state systems for regulating and taxing the business of insurance. This was done in two ways. One was by removing obstructions which might be thought to flow from its own power, whether dormant or exercised, except as otherwise expressly provided in the Act itself or in future legislation. The other was by declaring expressly and affirmatively that continued state regulation and taxation of this business is in the public interest and that the business and all who engage in it 'shall be subject to' the laws of the several states in these respects.
>
> "Moreover, in taking this action Congress must have had full knowledge of the nation-wide existence of state systems of regulation and taxation; of the fact that they differ greatly in the scope and character of the regulations imposed and of the taxes exacted;

> and of the further fact that many, if not all, include
> therefore, this case turns as a matter of law as applied
> generally to other interstate business. Congress could not have been unacquainted with these facts and its purpose was evidently to throw the whole weight of its power behind the state systems, notwithstanding these variations." *Prudential Ins. Co. v. Benjamin*, 328 U. S. 408, 429-430.

See also *Wilburn Boat Co. v. Fireman's Ins. Co.*, 348 U. S. 310, 318-321; *Securities & Exchange Comm'n v. Variable Annuity Co.*, *supra*, at 68-69, and dissenting opinion at 82, *et seq.*

If innovations in the policy of the McCarran-Ferguson Act are thought desirable, they should be made by Congress, not by us.

I would affirm.

The facts that control this decision is not in dispute; therefore, this case turns on as a matter of law as applied to undisputed facts. To illustrate: Section 26 U. S. C. A. 801 provides that there is one and only one test in the statute as passed by the Congress, and that is, if the taxpayer has more than 50% life reserves then the taxpayer is a life insurance company under the Federal law and no limitations or exceptions. The taxpayer's three annual statements, covering the tax years 1963, 1964, and 1965, the testimony of Mr. John L. Reynolds, Deputy Commissioner, and the testimony of two State actuaries confirmed the fact that the taxpayer's direct reserves (not reinsured) life reserves were more than 50%. In fact, they were 100%.

Now we quote from the certificate of Deputy Commissioner John L. Reynolds:

DEPARTMENT OF INSURANCE
Federal Land Bank Building—1401 Hampton Street
Columbia, South Carolina 29201

INSURANCE COMMISSION
Edward Kronsberg
Claude E. McCain
James C. Self
Edward W. Vereten
E. Fort Wolfe

JOHN W. LINDSAY
Chief Insurance Commissioner

June 28, 1971

Certificate

During the years 1963, 1964 and 1965, the Reserves were required by law in South Carolina on Life Insurance. This Reserve was calculated basically on a mortality base.

The examiners of this Department have examined the records for the Industrial Life Insurance Company for 1963 and 1966. For the year 1963, the examiner's Reserve calculations agreed with those of the Company; and in 1966, the examiners increased the Company's Reported Reserve by $30.00.

This Department has accepted the Reserve figures as reported by the Company for the years 1964 and 1965.

The Reserves reported by the Company and examined and/or accepted by this Department were Reserves on Life Policies and Contracts only.

/s/ JOHN L. REYNOLDS,
Deputy Commissioner,
Administration.

JLR:jcm

TAXPAYER'S NOTE: This statement was inadvertently left on the Judge's desk by the Judge, and he issued a special order that this statement be a part of the official record as sent to Richmond. The truth in the matter is that this statement by the Insurance Department and their three annual reports show that we had policies in force, reserves calculated, and assets to meet the reserves, and this is all the taxpayer needed under Section 801.

During the reign of *Paul v. Virginia,* the courts took the position that the states had a free hand in the management, control, and regulation of the insurance industry, which is cited as *Securities and Exchange Commission v. National Securities, Inc.,* 89 S. Ct. 564 (1969):

> "... **In context, however, it is relatively clear what problems Congress was dealing with. Under the reign of Paul v. Virginia, supra, states had a free hand in regulating the dealings between insurers and their policyholders.** Their negotiations, and the contract which resulted, were not considered commerce and were therefore left to state regulation. The Southeastern Underwriters decision threatened the continued supremacy of the states in this area. **The McCarran-Ferguson Act was an attempt to turn back the clock, to assure that the activities of insurance companies in dealing wih their policyholders would remain subject to state regulation.**"

This case was the last case that has been before the Supreme Court involving the McCarran-Ferguson Act, which decision fully supports this taxpayer's position.

The main question before this court is did the taxpayer meet the words of the Federal Statute Section 201 defining a life insurance company, and the taxpayer contends that it did and no one other than the Congress itself can change the tax laws. So, the first question is, did the taxpayer have more than 50% of its total reserves in life reserves, and this is admitted by the U. S. Government in the next four paragraphs.

On June 30, 1970, the Internal Revenue Section in Washington advised the Columbia Revenue office, and on page 2 of this letter, paragraphs 4 and 5, we quote:

> "The issue presented is whether the taxpayer is a life insurance company within the meaning of section 801(a) of the Code for the taxable years under examination."

> **"Section 801(a) of the Code provides in part and in substance that for purposes of subtitle A of the Code, a life insurance company is an insurance company which is engaged in the business of issuing life insurance and annuity contracts 'if—(1) its life insurance reserves . . . comprise more than 50 percent of its total reserves . . .' "**

However, in paragraph 6, the Internal Revenue Service in Washington held that the taxpayer did not qualify under Federal Regulation 1.801-3(a) (1), and we quote:

> **"Under the facts presented, the taxpayer would clearly meet the reserve requirements of section 801(a) of the Code for purposes of qualifying as a life insurance company, and accordingly, would be a life insurance company under that Code provision if it first qualifies as an 'insurance company.' The 'insurance company' question is, therefore, the real question to be resolved here. In this regard section 1.801-3(a)(1) of the Income Tax Regulations provides:"**

The real and final question is can the Internal Revenue Service amend, change and enlarge, and rewrite, the terms of Section 801 by their own Federal regulation 1.801-3(a)(1) as prepared by the Secretary of the Treasury.

Therefore, the Congress in 1921, long after the decision of *Paul v. Virginia* (1869) set one standard and one alone as the test of a life insurance company for Federal tax purposes and that was the more than 50% life reserve test, in the present Federal Code Section 801. All other regulatory matters were of necessity left to state regulation since 1869, the date of *Paul v. Virginia*, which held insurance not interstate commerce and not subject to Federal regulation under the commerce clause. When the Revolutionary War ended, about 50-60 miles below Richmond, Virginia, at York Town, Virginia, the colonies had been burdened to death by taxation without representation. So, in the early portion of the Federal Constitution, in Article I, Section 8, the Constitution provided that only the Congress can lay and collect taxes. Therefore every taxpayer in the U. S. is tremendously interested in this case because Section 801 is plain, simple, and unambiguous. Since the sole purpose of any regulation is to simplify and make clear the technical language of the Statute, in this case there is no reason or justification for Federal Regulation 1-801.3(a), and we quote Volume 1 of Mertens Construction of Tax Statutes, Section 3.25 which defines when a Regulation can be valid, binding and effective, and when it cannot be valid, binding and effective, and we quote:

> ". . . It merely clarified what the language of the statute always was intended to convey. **It does not, and could not alter the statute . . .**"

In the case at court, the Regulation cannot be effective according to the terms of Mertens, and is therefore void and of no effect. We support Mertens ruling by citing *Service Life Insurance Company v. U. S.*, 293 F. (2d) 72(1961) at p. 77 (2 Cir.):

> (2) ". . . Since the ruling clearly contravened the law, it was without legal effect. It is elementary that revenue rulings and even Treasury Regulations are without force if they are in conflict with the statute. *Boykin v. Commissioner of Internal Revenue*, 8 Cir., 260 F. (2d) 249, 254."

Now we move to another regulatory feature as performed by the South Carolina Insurance Department pursuant to its authority under the McCarran Ferguson Act. It is interesting to know that by the terms of the McCarran Ferguson Act, the states' regulatory system had the absolute power and authority to regulate and manage the insurance industry within their own boundaries and regardless of where the insurance company's main office was or which state in which it was chartered, its reserves were calculated according to S. C. in which it was doing business and not where it was chartered; therefore, each state had the power to pass its own reserve statute and by the same token it had the power to evaluate the reserves held by each taxpayer to see if it met the local state reserves, and we quote from the three leading texts on this subject.

The three leading textbooks all support our reserve theory. One: That since the taxpayer's business was limited to South Carolina its policies all had to be based on the S. C. Reserve statute, which is not in question. Two: The following textbooks all hold that South Carolina has the absolute right to evaluate the assets to be sure taxpayers can pay claims when they arrive, and not IRS or the Federal Courts.

In Volume 8 of Mertens Insurance Tax Law, Sec. 44.26, 1971 Supplement, this is said in part:

> In this respect Congress has left it to the states to determine the amount of funds which must be reserved by insurance companies to provide for the various obligations assumed under the many different forms." Funds and reserves both mean investments

To the same effect, see *Federal Income Taxation of Insurance Companies*, 2nd Ed. by Richard L. Denny, etc., 1960, by the Ronald Press Company of New York:

> " . . . Congress had left to the states the determination of the amounts which must be reserved by insurance companies to provide for their liability to policy holders under the various types of contracts written."

And also to the same effect in *Federal Income Taxation of Insurance Companies* by Lybrand, Ross Brothers, Montgomery, in Chapter 1, page 10, we quote 1961 edition in part:

> " . . . Congress had left to the states the determination of the amounts which must be reserved by insurance companies to provide for their liability to policyholders under the various types of contracts written."

In *General Life Insurance*, 137 F. (2d) 185, (C.C.A. 5th, 1943) Texas took the position that the State Legislature and not the Federal Government had control of Reserve funds and the power to fix the amount of the reserve funds. (Before the McCarran Ferguson Act.)

> " . . . **We know of no prohibition in the organic law that prevents the State of Texas from determining the amount of reserve . . . necessary to fulfill contracts of insurance entered into by Texas companies.** The fact that it is called a Mortuary Fund instead of a Reserve Fund is of no consequence, but it is important that the fund, by whatever name called, as required by the law of Texas, be held for the fulfillment of claims of depositors . . . "

Also in this opinion, the Circuit Court discussed the fact that insurance company reserves varied in amounts from state to state. Citing *Maryland Casualty Company v. U. S.*

251 U. S. 342, the 5th Circuit Court of Appeals made its own observation along this line:

It is elementary that if a life insurance company desires to do business in South Carolina, its policies must be based on the South Carolina Reserve Statute, regardless of whether it is on intrastate or interstate business. No better illustration of this fact could be pointed out than the *General Insurance Company* case, 137 F. (2d) 185 (CCA 5) just quoted from Texas where the Fifth Circuit Court held that the state had the absolute right to pass on the Texas Reserve Statute; and, of course, the State of Texas had a right to approve the reserves not only in calculated amounts but in dollars and cents. We cite the three leading texts in the U. S. on pages 42-43 of this petition in support thereof. In fact, reserves are both mathematical calculations and the supporting assets, which is one and the same thing.

Now, to illustrate that South Carolina had the power to regulate the taxpayer and had regulated the taxpayer, we cite a financial summary of the three tax years involved where the South Carolina regulatory system had, first, checked the annual statements and, secondly, had made its three-year annual on the spot audit as supported by the certificate of John L. Reynolds dated June 28, 1971, which three annual reports by the then Commissioner to the Governor and legislature showed their regulatory judgments in the five different categories pursuant to state statute 37-281 and as interpreted by the South Carolina Supreme Court in *Calhoun Life Insurance Company v. Gambrell* and which judgments had been approved and certified over the name for the three years namely Charles W. Gambrell. Then here comes the same Mr. Gambrell now Assistant U. S. District Attorney who was head of the South Carolina insurance Regulatory Department during the three years in question and who as South Carolina's Chief Commissioner had actually signed these three annual reports to the Governor and Legislature showing these five different regulatory final judgments for each of the three years in question, which the Governor and the State legislature had a right to depend upon as S. C. official judgments, but now as Assistant U. S. District Attorney proceeds to tear down and falsify these regulatory judgments made pursuant to the authority granted under the McCarran Ferguson Act. So, the insurance industry again finds itself in a state of turmoil because the District Court and the Fourth Circuit Court of Appeals have refused to abide by the terms of the Congressional Act known as the McCarran Ferguson Act, which the heretofore mentioned cases have followed religiously, which McCarran Ferguson Act specifically gave the states absolute power to make these regulatory judgments final in their regulatory capacity, but here again we find the various circuits in turmoil as to their interpretation of the McCarran Ferguson Act and to its validity, or in fact, the District Court and the Fourth Circuit Court of Appeals refused to admit the Congress' legislative power to pass the laws. But, instead, in this case are allowing the President and his assistant secretary of the treasury, by regulation, to override, change, and render void the Acts of the Congress defining a life insurance company.

In both the *Swift* and *Service Life* cases, the following views were expressed by the Court:

> "Taxpayer is entitled to have Section 201(a) (now Section 801) liberally construed in determining whether it is a life insurance company within its terms. Where there is a reasonable doubt as to the meaning of a taxing act, it should be construed most favorably to the taxpayer." Syllbus 3, p. 625; Swift and Company, 151 F. (2d) 625 (1945) Key No. 826; Revenue Act 1936 SS201(a), 26 U. S. C. A. Int. Rev. Acts, p. 898.

We quote from Syllabus 4, p. 625:

> "Where there is reasonable doubt as to meaning of a taxing act, it should be construed most favorably to taxpayer." (Syllabus 4, p. 625) Key No. 126.
>
> [3] ". . . Furthermore, 'The taxpayer is entitled to have SS201(a) liberally construed in determining whether it is a life insurance company within its terms.' *Commissioner v. Swift & Co., Employees Benefit Association,* 7 Cir. 151 F. (2d) 625, 628."

The net effect of the government's Federal regulation is that it robs the states of their actual management, control, and regulation of the insurance industry of the various state insurance departments. In effect, the government has had the District Court in this case and the Cardinal Life Court to change and enlarge Sec. 801 of the Federal Code which is the duty of the Congress and not the courts.

It is elementary that if a person or corporation wants to do business in South Carolina or any other state, it or he must agree to be bound by the local state laws. Particularly is this true if the proposed operation to be done is clothed with a public interest such as the practice of law, medicine, or the insurance business; therefore, the Congress realized in the passage of the McCarren-Ferguson Act that the state had the power to regulate the insurance business because it is clothed with a public interest. As to the fact that the South Carolina Legislature has Regulatory Authority over the Insurance business we cite the case of *Paul v. Virginia,* 1869, and *LaTourette v. McMaster* decided June 27, 1916, by the Supreme Court of South Carolina, 104 S. C. 51 and approved by the Supreme Court of U. S. in 248 U. S. 465, forever decided and put at rest that the State of South Carolina has the power of regulation and 44 C. J. S. under Insurance Sec. 56457 and S. C. Code Vol. 8 at pages 239, 294, and 295 and all agree and support, so it cannot be questioned that since our charter was granted in 1939 after 1908 the year that South Carolina began regulating insurance companies and since our charter was issued 31 years after that date, that our charter was granted pursuant to the legislative regulatory powers and that ours is a contract in law between the South Carolina Legislature and our company and that every pertinent provision of the South Carolina Legislature and our company and that every pertinent provision of the South Carolina Regulatory Law as to insurance companies is presumed and impliedly written into our charter and we cite as additional authority 18 C. J. S. Sec. 71, Page 456, and we cite the *Dartmouth College* case and *Jones v. St. Louis Structural Steel Company,* 267 Ill. App., 576, see footnote 57 on page 457, of 18 C. J. S. Sec. 71.

The truth of the matter is that when the state issued the taxpayers charter it provided for all forms of investments which supported the reserves, in the State Regulatory capacity. Now we quote the charter issued 1939, which state Regulatory power under Sec. 2B of McCarran-Ferguson Act, could not be controlled by the Government or I. R. S.

> "To issue contracts of insurance against all hazards, including sickness, death, casualty and liability, and all other forms of insurance; **to buy, sell, mortgage, and lease real estate and to do all things necessary and incident to the above powers.**"

The Supreme Court of the United States, in the case of *Dartmouth College v. Woodward,* 17 U. S. 518 (1816), held that the granting of a Charter by New Hampshire to the Trustees of Dartmouth College was a contract between the Trustees of Dartmouth College and the State of New Hampshire and that the contract was not revocable by the State of New Hampshire. Immediately the various state legislatures amended their law to provide that all charters granted after that date were subject to revocation by the legislature itself.

The South Carolina Constitution of 1895, in Article 9, Section 2, gives the State of South Carolina, through its legislature, absolute power to amend, modify, or repeal any charter issued after 1841. See *Witt v. Peoples State Bank*, 164 S. E. 306, 166 S. C. 1; and see Attorney General's Opinion No. 1578 dated December 30, 1963, citing the *Witt* case as authority and we quote from the *Witt* case:

> "The charter of every corporation is subject to the reserved right of the State to amend, modify or repeal all charters now existing or hereafter created shall be subject to future repeal or alteration." Constitution of South Carolina 1895, Art. 9-2.

Since the taxpayer's charter was a contract made by the State of South Carolina pursuant to the legislative authority and pursuant to the fact that South Carolina Supreme Court had held in the case of *La Tourette v. McMaster* (1919) and approved by the Supreme Court of the U. S. in 248 U. S. 465 that the insurance business was clothed with a public interest in South Carolina and subject to regulation therefore by the State of South Carolina and since the taxpayer's charter has not been revoked nor changed by the legislature, then it is subject to regulation under 2(b) of the McCarran Act, and the charter itself gives the taxpayer the authority to buy, sell, mortgage, and lease real estate that is incidental to the insurance business in this case.

See the case of *Solomon L. Miller v. Richmond and Danville R. R. Company* cited as 93 U. S. 348 (1876) which case held that South Carolina legislature is the only one that can change its charter after 1841.

The *Prudential* opinion explains the McCarran Ferguson Act.

> "Moreover, in taking this action Congress must have had full knowledge of the nation-wide existence of state systems of regulation and taxation; of the fact that they differ greatly in the scope and character of the regulations imposed and of the taxes exacted; and of the further fact that many, if not all, include features which, to some extent, have not been applied generally to other interstate business. Congress could not have been unacquainted with these facts and its purpose was evidently to throw the whole weight of its power behind the state systems, notwithstanding these variations." *Prudential Insurance Company v. Benjamin*, 328 U. S. 408, 430-431.

Finally, and in conclusion, the Court in the *Prudential* case summarized the decision in these words:

> **"The other was by declaring expressly and affirmatively that continued state regulation and taxation of this business and all who engage in it shall be subject to the laws of the several states in these respects." (90 L. Ed. 1342 (1946))**

On page 305 of *FTC v. Travelers Health*, Judge Harland said (362 U. S. 293):

> "The same is true, in my opinion, of expressions made during the debate relating to the desirability of leaving insurance regulation to local authorities because they were, so to speak, 'on the ground,' expressions which, the Court correctly observes, reflected a basic motivating policy behind the legislative movement that culminated in the enactment of the McCarran-Ferguson Act."

It is fundamental and elementary in contract law that you can't make or create a binding or valid contract without the mutual consent and agreement of the parties involved. This is exactly the situation that this court is confronted with so far as the taxpayer liabilities are concerned as its eighteen hundred reinsurance policy contracts bindities and that were still in force in the tax years of 1963, 1964, and 1965 and still being collected by the Reinsurers as subcontractors of the taxpayer and still liabilities of the taxpayer because there never was, on the part of the policyholders, an agreement to cancel or release their claim against the taxpayer. Therefore, it is eminently clear that to cancel a contract you have to have a mutual agreement, or in other words, a novation and that is exactly what *Empire Insurance Company v. Landman*, 104 So. 425 holds and which finding is basically correct, and we quote from *Empire Insurance Company v. Landman*, in part:

> "Insurer could not, without policy holder's knowledge or consent, make contract of insurance which abrogated rights of insured against original insurer."

And is one of the many cases cited by Couch on insurance, and we quote in part 2nd Ed., Vol. 19, Sec. 80-61, page 953:

> "Regardless of the nature of the reinsurance contract, the original insurer remains liable to the original insured, in the absence of a novation, that is, an original insurer cannot, without the knowledge or consent of the insured, enter into any contract of reinsurance with another company which abrogates or alters the rights of the insured as against it, the original insurer. And an insurance company taking over the business of another company cannot change the contracts of the latter with the parties insured therewith without their consent."

Also, along this same line, we cite Appleman on Insurance, Vol. 13, Section 771, at page 510 where this is said in part:

> "The insurer could not, however, without the policyholder's knowledge or consent, make a contract of reinsurance which abrogated the rights of the insured against the original insurer."

Again, we quote from *Alinco Life* as to this taxpayer being liable to policyholders without a release or novation:

> "Nowhere is the slightest suggestion made (nor could there be) that Alinco was not legally bound to its obligations under the reinsurance treaty. Rather the Government chose to ignore, or at most to make light of those obligations apparently on the ground that the risks undertaken by Alinco, were mostly illusory due to the fact that the average mortality cost within a $1 premium was in the neighborhood of 28¢. From this it is argued that credit life insurance underwriting is a highly profitable business and that, since Old Republic's financial strength was such that it had no actuarial need to reinsure any part of its policies the normal expectation would be refusal by Old Republic's share with anyone its profitable premium income unless there were some clever tax scheme afoot."

As to whether or not the taxpayer was still liable on the eighteen hundred reinsured policies reinsured in 1947 and in 1953 which were still in force in the tax years.

The court erred in not holding that the taxpayer did not have the power by reinsurance contract or otherwise to cancel its contract with its own policyholders or to get off the risk without a novation, and no better illustration could be had than in the case of *Lynch v. United States*, 292 U. S. 57 (34) where the Congress tried to get off war risk insurance without the Veteran's or policyholder's agreement. The Supreme Court of the United States held as in the case at bar now at court that they could not do so, and we quote: When the taxpayer was considering liquidating the taxpayer's corporation, the South Carolina Insurance Department objected on the theory the taxpayer was still on thousands of reinsured risks by reason of not having gotten releases from the policyholders or no novations. See *Lynch v. U. S.*, 292 U. S. 57 (1934).

"Second. The Fifth Amendment commands that property be not taken without making just compensation. Valid contracts are property, whether the obligor be a private individual, a municipality, a state, or the United States. Rights against the United States arising out of a contract with it are protected by the Fifth Amendment. *United States v. Central Pacific R. Co.*, 118 U. S. 235, 238, 6 S. Ct. 1038, 30 L. Ed. 173; *United States v. Northern Pacific Ry. Co.*, 256 U. S. 51, 64, 67, 41 S. Ct. 439, 65 L. Ed. 825. When the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals. That the contracts of war risk insurance were valid when made is not questioned. As Congress had the power to authorize the Bureau of War Risk Insurance to issue them, the due process clause prohibits the United States from annulling them, unless, indeed, the action taken falls within the federal police power or some other paramount power."

* * *

II

Taxpayer did not accumulate its earnings beyond the reasonable needs of its business and is not, therefore, subject to the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code.

The Accumulated Earnings Tax imposed on certain corporations by Section 531 is applicable to the taxpayer corporation only if it has been ". . . availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." (IRC Sec. 532, Add., p. 1.) If the taxpayer corporation can show by a preponderance of the evidence that the earnings and profits of the corporation have not accumulated beyond the reasonable needs of the business, the accumulated earnings tax of Section 531 is not applicable. (IRC Sec. 533 (a), Add. p. 1.) "Reasonable needs of the business" includes the **reasonably anticipated needs of the business**. (Emphasis added.) (See IRC Section 537 (1), Add., p. 4.) Taxpayer contends that reasonably anticipated needs would without a doubt include contingent needs of a business. As has been said by the Fourth Circuit Court on a prior occasion, a contingency is a reasonable need for which **a business may provide if the likelihood of its occurrence reasonably appears to a prudent businessman**. *Smoot Sand & Gravel Corp. v. Commissioner*, 241 F. (2d) 197, 206 (4th Cir. 1957). (Emphasis added.)

A. The Courts Incorrectly Applied the Law in Reaching their Decision.

The business judgment of taxpayer's management is an essential determination in accumulated earnings tax cases. An inquiry must be made into the state of mind of **those controlling the corporation**. (Emphasis added.) Other courts have expressed the significance of such an inquiry in reaching decisions in such cases.

> "Determination of the reasonable needs of its business is, in the first place a task for the officers and directors of the corporation. What is reasonable in one situation may be unreasonable in a different context of facts. We should be hesitant to attribute a sinister or ulterior motive to the corporation unless such a factual situation clearly appears. The law contemplates that any legitimate business may grow if legitimate means be employed." *Crawford Publishing Co. v. C. I. R.*, 17 T. C. 1404.

Language from an accumulated earnings tax case in the Federal District Court for Mississippi is illustrative of the considerations which should face the Court in reaching a decision concerning whether or not the accumulated earnings tax is applicable to a given situation. Quoting from an opinion by Judge William Harold Cox finding the accumulated earnings tax inapplicable to the corporation taxpayers:

> "The business judgment of these experienced people as to their business requirements for the proper and safe and sound conduct of such businesses is entitled to great weight. The defendant offered no proof in this case but relied upon evidence and testimony elicited on cross examination. It must be borne in mind that the subject tax is of the nature and character of a penalty and must be cautiously applied and enforced accordingly. These taxpayers have paid large sums of money as ordinary income taxes on their taxable income for these three years and should not be mulcted in penalties. It would have been helpful if some tangible plan had been prepared and approved for retaining such funds for some announced specific use, but that is not indispensable to a justification of the taxpayers' position here. These prospective expenditures were not mere possibilities but were probabilities in future planning for the continued existence and expansion of these corporations, and the accumulated earnings of these corporations for these three years were not even adequate to meet said needs and requirements. *Hardin's Bakeries, Inc. v. Martin*, 293 F. Supp. 1129 (S. D. Miss. 1967).

In *Dahlem Foundation, Inc. v. U. S.*, 405 F. (2d) 993 (6th Cir. 1968), the Sixth Circuit reversed a finding by the District Court that the taxpayer was subject to the accumulated earnings tax of I.R.C. Section 531. The opinion quotes from the *Hardin's Bakeries, Inc.* case *supra* concerning the weight to be given to management judgment and further states that:

> "If the Government's views were to be accepted, they would give to the treasury virtually absolute power to stifle or encourage economic growth as it—

not the corporate directors—would then decide how each company should handle its corporate and financial affairs." *Dahlem Foundation, Inc., supra.*

The Fourth Circuit case of *Smoot Sand & Gravel Corp. v. Commissioner,* 241 F. (2d) 197 (4th Cir. 1957) involved an accumulated earnings tax case, one of the issues of which concerned the applicability of the tax to reserves accumulated by the taxpayer to provide for the contingency of having to enter the ready-mix concrete business in order to protect its market for sand and gravel. The Tax Court below had decided that such a reserve was not a reasonable business need and was therefore subject to the accumulated earnings tax. The Court speaking through Judge Sobeloff disagreed:

> "The Tax Court, refusing to recognize that a reserve for such a need was reasonable, stated that 'petitioner never planned or intended to go into the ready-mix business of its own free will, and the contingency which might have forced it to do so never developed.' We think this was an improper way to dispose of the issue and that the reason assigned is not responsive to the claim asserted by the petitioner. If it was reasonable to anticipate a need for the petitioner to expand its business operations into the ready-mix field, it is immaterial that such expansion would not be voluntary. Nor is it a conclusive answer that the contingency never, in fact, arose to force petitioner to enter this new business area. These circumstances do not reach the issue. **What is material is whether or not petitioner reasonably believed that it might be forced into the ready-mix business as a defensive measure, and whether it reasonably intended to enter such business when and if the imminence of the threat should demand it.** The fact that such a step would be taken involuntarily would not make the need less compelling. If the petitioner reasonably feared the contingency it had the right to protect itself by providing a reserve

for this purpose. *Smoot Sand & Gravel Corp., supra.* (Emphasis added.)

From the foregoing language of Judge Sobeloff we see the following test: "**Whether or not petitioner reasonably believed that it might be forced into the ready-mix business . . . and whether it reasonably intended to enter such business when and if the imminence of the threat should demand it.** (*Smoot Sand & Gravel Corp., supra*, emphasis added.) This test was not squarely faced in the present case. The District Court seemed to base its finding on the fact that (1) during the tax years in question South Carolina did not require that taxpayer meet the initial capital and surplus requirements of S. C. Code Section 37-181 (Add., p. 1); and (2) if the taxpayer really desired to increase its capital and surplus it should do so by increasing its premium income and by the sale of additional stock. The fallacy of such reasoning is clearly apparent. First of all, the statute provides that a contingent or reasonably anticipated need is all that is required. (IRC Section 537 (1) *supra.*) The fact that a statute requiring taxpayer to meet the capital and surplus requirements of new insurance companies had not yet been passed is therefore immaterial. Note that there is such a statute now pending before the South Carolina Legislature. (Add., p. 1.) Second, the premium income of taxpayer increased in each of the years in question. Taxpayer was in fact increasing its premium income. (Add., p. 1.) Third, the suggestion that taxpayer sell more stock is a suggested course of the Government and the Court below. This may not have occurred to be a reasonable course from taxpayer's standpoint in view of the fact that sale of additional stock necessitates a proportionate loss of control of the corporation by the existing stockholders.

The Court should not impose its business judgment on that of the taxpayer management. The test applied in the

Smoot Sand & Gravel Corp. case should be applied here. As was said in *Balan Textile Machinery Company v. U. S.*, "Since liability for this tax depends on the purpose underlying the accumulation, **inquiry must be made into the state of mind of those controlling the corporation.**" 453 F. (2d) 1100, 1101 (4th Cir. 1972). (Emphasis added.)

Consequently, the foregoing test should have been applied here. Did the taxpayer's management reasonably believe that it needed to provide for the contingencies which faced it? This is the question which must be answered. It is apparent from the findings of the District Court that this test was not applied. Taxpayer contends that this amounts to an error of law.

B. Even if the District Court correctly applied the Law in reaching its decision, its conclusion that taxpayer allowed its earnings to accumulate beyond the reasonable needs of the business is clearly erroneous.

Taxpayer further contends that if the law had been properly applied to the evidence in the case, a finding in favor of the taxpayer would have been imperative. Any finding to the contrary is clearly erroneous. In the present case the taxpayer corporation was not availed of for the purpose of avoiding income tax to the stockholders but rather accumulated its earnings and profits in order to provide for reasonably anticipated needs of the business. The taxpayer was chartered in 1929 with original paid in capital in the amount of $2,500.00. (App., p. 122-A.) At that time such amount of capital was sufficient to meet the requirements for acquiring an insurance company charter. Thereafter, in 1947, the State of South Carolina passed its first statute relating to capital and surplus requirements requisite to obtaining an insurance company charter. Under a so-called "grandfather clause" insurance charters in existence at that time were allowed to continue

> for this purpose. *Smoot Sand & Gravel Corp., supra.* (Emphasis added.)

From the foregoing language of Judge Sobeloff we see the following test: "**Whether or not petitioner reasonably believed that it might be forced into the ready-mix business . . . and whether it reasonably intended to enter such business when and if the imminence of the threat should demand it.** (*Smoot Sand & Gravel Corp., supra,* emphasis added.) This test was not squarely faced in the present case. The District Court seemed to base its finding on the fact that (1) during the tax years in question South Carolina did not require that taxpayer meet the initial capital and surplus requirements of S. C. Code Section 37-181 (Add., p. 1); and (2) if the taxpayer really desired to increase its capital and surplus it should do so by increasing its premium income and by the sale of additional stock. The fallacy of such reasoning is clearly apparent. First of all, the statute provides that a contingent or reasonably anticipated need is all that is required. (IRC Section 537 (1) *supra.*) The fact that a statute requiring taxpayer to meet the capital and surplus requirements of new insurance companies had not yet been passed is therefore immaterial. Note that there is such a statute now pending before the South Carolina Legislature. (Add., p. 1.) Second, the premium income of taxpayer increased in each of the years in question. Taxpayer was in fact increasing its premium income. (Add., p. 1.) Third, the suggestion that taxpayer sell more stock is a suggested course of the Government and the Court below. This may not have occurred to be a reasonable course from taxpayer's standpoint in view of the fact that sale of additional stock necessitates a proportionate loss of control of the corporation by the existing stockholders.

The Court should not impose its business judgment on that of the taxpayer management. The test applied in the

Smoot Sand & Gravel Corp. case should be applied here. As was said in *Balan Textile Machinery Company v. U. S.*, "Since liability for this tax depends on the purpose underlying the accumulation, **inquiry must be made into the state of mind of those controlling the corporation.**" 453 F. (2d) 1100, 1101 (4th Cir. 1972). (Emphasis added.)

Consequently, the foregoing test should have been applied here. Did the taxpayer's management reasonably believe that it needed to provide for the contingencies which faced it? This is the question which must be answered. It is apparent from the findings of the District Court that this test was not applied. Taxpayer contends that this amounts to an error of law.

B. **Even if the District Court correctly applied the Law in reaching its decision, its conclusion that taxpayer allowed its earnings to accumulate beyond the reasonable needs of the business is clearly erroneous.**

Taxpayer further contends that if the law had been properly applied to the evidence in the case, a finding in favor of the taxpayer would have been imperative. Any finding to the contrary is clearly erroneous. In the present case the taxpayer corporation was not availed of for the purpose of avoiding income tax to the stockholders but rather accumulated its earnings and profits in order to provide for reasonably anticipated needs of the business. The taxpayer was chartered in 1939 with original paid in capital in the amount of $2,500.00. (App., p. 122-A.) At that time such amount of capital was sufficient to meet the requirements for acquiring an insurance company charter. Thereafter, in 1947, the State of South Carolina passed its first statute relating to capital and surplus requirements requisite to obtaining an insurance company charter. Under a so-called "grandfather clause" insurance charters in existence at that time were allowed to continue without meeting the capitalization requirements spelled out in the new statute. (See S. C. Code No. 37-183 for present form of "Grandfather" clause. (Add., p. 1.)

Since that time the original statute has been amended several times, so as now to require stock insurance companies licensed to write life, accident and health insurance, as the taxpayer is so licensed, to have a minimum initial capital and surplus of $600,000.00. (See 1962 S. C. Code Ann. § 37-181 as amended 1971. (Add., p. 1.)

Although the taxpayer has not been required to meet the full amount of the new capital requirements because of the "grandfather clause", the trend over the years has been to upgrade the capital requirements of the companies, such as taxpayer, operating under the "grandfather clause" statute. The trend toward increased capital and surplus for "grandfather clause" companies is expressly indicated by the 1963 amendments to the grandfather clause section of the South Carolina Code. (See S. C. Code § 37-183, 37-183-1, 37-183.2, as amended 1971—(Add., p. 1.) The amendments require that (1) any stock company, such as taxpayer, must maintain no less than the amount of capital stated in its 1963 annual statement filed with the Chief Insurance Commissioner and, in addition, must maintain an unassigned surplus of not less than twenty-five percent of such amount of capital. (S. C. Code Section 37-183, *supra*), (Add., p. 1); and (2) any company that fails to meet the minimum capital and surplus requirements of Section 37-181 [grandfather companies such as taxpayer] must confine its business to the kind of insurance for which it was licensed on December 31, 1962; if it desires to write additional types of insurance, it must comply with the capital and surplus requirements of Section 37-181. These amendments explicitly show the legislature's upgrading of the capital and surplus requirements of "grandfather" companies.

An even more pronounced indication of the trend toward upgrading the capital and surplus requirements of "grandfather clause" companies such as taxpayer can be seen from a bill which is presently before the South Carolina General Assembly, to further amend the "grandfather clause", Section 37-183, S. C. Code, *supra*. The proposed 1973 amendment would further upgrade the requirements of "grandfather clause" companies, by adding the following language to the present Section 37-183:

> (f) The provisions of this section shall not apply to any insurance company described herein after April 1, 1976, and **no such insurance company shall thereafter remain licensed to do business in this State unless it meets the minimum requirements of Section 37-181** . . . (Bill No. 14 introduced in South Carolina General Assembly 2-15-73 by Senators Bristow, Long and Stevens.) (Emphasis added.) (Note—this proposed amendment is not a part of the record below and is used here merely to support taxpayer's argument that its expectation of such an amendment was reasonable.) (For entire amendment, see Brief, p. 60.) If this 1973 amendment becomes the law of South Carolina, it would amount to the elimination of "grandfather" companies by 1976. At such time all insurance companies would have to meet the minimum capital and surplus requirements of South Carolina Code Section 37-183 of $600,000.00 in capital and surplus (*supra*) in order to be licensed in the state. What could be a clearer indication of the trend to upgrade the capital and surplus requirement of "grandfather" companies, such as taxpayer?

The proposed amendment just discussed was apparently prompted by the **South Carolina Insurance Commission Legislative Recommendations** included in the 65th An-

nual Report for fiscal year ended June 30, 1972. Pertinent portions of the Report follow:

The Fourth Circuit in a recent case styled *Inland Terminals, Inc. v. U. S.*, 477 F. (2d) 836, where there was a parent company that had sizable sums of money and they could get money from the parent company almost at will was held not to meet the terms and conditions of Section 531. On the other hand, this taxpayer had no parent company to draw on and the present Insurance Commissioner was recommending that the taxpayer be required to have twice as much capital and surplus in 1976 as its total assets were the day of trial, and, of course, the facts in this *Inland Terminals, Inc.*, case have no connection with this case now at bar, and we quote from the recommendation of the Insurance Study Committee to the legislature which is self explanatory:

> "His Excellency, John C. West
> Governor, State of South Carolina
> State Capitol
> Columbia, South Carolina
>
> Dear Governor West:
>
> As required by law, we respectfully submit the Sixty-fifth Annual Report of the Department of Insurance of the state of South Carolina covering the period July 1, 1971 through June 30, 1972.
>
> Although the legislative sessions of 1971 and 1972 produced a number of major items of insurance legislation, we find that the need for new tools of regulation and modification in the existing law is continual. Accordingly, we have summarized our recommendations for the 1973 session of the General Assembly on the following pages. We plan to submit these recommendations to the Insurance Law Study Committee and, in addition, will provide each member of the General Assembly an advance copy of these proposals. The Insurance Commission feels very strongly that these changes are necessary to discharge the statu-

tory responsibilities of this office and to respond to the needs of the general public and its government.

We wish to bring to your attention one specific recommendation which is so far-reaching in its implications that we felt it appropriate to separate this proposal from those that follow. More than a generation has passed since the last revision of the insurance statutes as a whole—that revision was prompted by the South-Eastern Underwriters Association's case and the subsequent Federal enactment of the McCarran Act. While there have been many substantive changes since 1947, we firmly believe that current conditions dictate reexamination of the entire body of insurance laws and regulations and the development of a new insurance code. As you are aware from your personal experience in the General Assembly, such a project involves extensive preparation and study, numerous conferences, extensive costs and a considerable expenditure of time. We sincerely hope that you and the able leadership in the General Assembly will initiate this project in the near future and we pledge our support and assistance in reaching this objective in the shortest possible time.

SOUTH CAROLINA INSURANCE
COMMISSION,

JOHN W. LINDSAY,
Chief Insurance Commissioner."

SOUTH CAROLINA INSURANCE COMMISSION

LEGISLATIVE RECOMMENDATIONS—1973

3. *Require all licensed insurers which do not currently meet the minimum capital and surplus statutory requirements to meet such requirements within 3 years if they are to remain licensed to do business in this State. Section 37-183.*

There are a number of licensed insurers which could not be licensed if they were formed today. In most cases they were formed many years ago. They are currently authorized to sell new policies to South Carolina residents although they do not meet the minimum capital and surplus requirements established by the Legislature in 1971 (Sections 37-181 and 37-182). They are currently protected by Section 37-183—the so-called "grandfather clause."

We feel that none of these insurers should be permitted to sell new policies to residents of the State unless they meet such requirements within 3 years.

Based on the foregoing, the trend was apparent; its occurrence and the concomitant need for "grandfather" companies to increase their net worth would undoubtedly appear to a prudent businessman to be a reasonably anticipated need of the business.

Clayton Scyphers, president of the taxpayer corporation, testified that during the years 1963, 1964 and 1965 he was aware of and very concerned about the impact of the foregoing trend on his corporation. (App., p. 138.) He further testified that he had allowed the earnings and profits of the taxpayer to accumulate as much as possible in order to meet the new capital and surplus requirements when and if they were imposed by the South Carolina Legislature. (App., p. 138.) Based on the trend to upgrade grandfather companies previously set forth, surely Mr. Scyphers was justified in his concern; his decision to accumulate profits and earnings seems to be a very prudent business decision. The contingency of the capital and surplus requirement being upgraded was real, not fantasy; increasing the net worth of taxpayer was, therefore, a reasonably anticipated need of the business.

Moreover, Mr. John L. Reynolds, who is presently Deputy Commissioner in Charge of Administration for the South Carolina Department of Insurance and who during the tax years in question was Chief Financial Analyst for the Department, testified that in his opinion it was most desirable that "grandfather" clause companies such as taxpayer increase their capital and surplus in order to meet the statutory requirements for new companies. (App., p. 129.) He further testified that he would have encouraged a company to do so and considered the statutory requirements to be a minimum goal of such companies. (App., p. 134.) Mr. Arthur Crooks Eddy, whose occupation is that of a consulting actuary, testified that in his opinion the taxpayer or any "grandfather" clause company should try to increase its capital and surplus to comply with the minimum statutory requirements for new companies on the grounds that it would be a "matter of good business judgment." (App., p. 29.) This testimony provides additional evidence that the earnings and profits were accumulated to provide for the reasonably anticipated needs of the business.

In addition to accumulating earnings in an effort to meet South Carolina statutory requirements, taxpayer contends that the accumulation of surplus was necessary in order to provide for contingent liability on the taxpayer policies which had been reinsured in the years 1948 and 1953. (Legal authority supporting this position is more fully set forth in Argument I, concerning taxpayer's status as a life insurance company for Federal Income Tax Purposes.) Taxpayer takes the position that it was legally liable on the reinsured policies. Clayton Scyphers, taxpayer's president, testified that he believed the taxpayer was legally liable to policyholders on policies even though reinsured, in the same manner that a general contractor is liable for the work of his subcontractors. (App., p. 138.) Evidence was offered to show that taxpayer had actually paid some claims on the policies. (App., p. 138.) However, whether this position is legally correct or not seems to be immaterial with respect to the accumulated earnings tax issue. What is important here is that the taxpayer's management in good faith believed that the contingent liability was present and based on this belief, accumulated surplus to provide therefor.

So in brief summary taxpayer contends that the profits and earnings were allowed to accumulate in order to provide for two contingencies: (1) new statutory requirements for capital and surplus which were apparently on the horizon; and (2) liability under insurance contracts which had previously been reinsured. Either of these contingencies would justify the taxpayer's accumulation of its earnings and profits in a greater amount than had been accumulated in any of the tax years in question. Taxpayer's management recognized the contingencies as reasonable business needs and allowed accumulation of earnings based thereon.

Of further **extreme** importance in this case is the fact that taxpayer during each of the tax years in question had actual life insurance risk exposure in excess of its total admitted assets and unassigned surplus. For example, in 1963 taxpayer had actual direct, not reinsured, life exposure of $280,460.00 as compared to an unassigned surplus account of $232,765.41; in 1964 taxpayer had actual direct, not reinsured life exposure of $310,364.00 as compared to an unassigned surplus of $260,018.06; and in 1965 taxpayer had actual direct, not reinsured life exposure of $362,392.00 as compared to unassigned surplus of $269,099.38 (App., p. 124.) In view of the foregoing evidence, a finding of unreasonable accumulation of earnings and profits seems clearly erroneous. The very nature of an insurance company would seem to preclude the imposition of the accumulated earnings tax. The entire thrust of state law is toward higher capitalization and unassigned surplus requirements for insurance companies. It is a matter of public interest and welfare. The anomaly which is created by the imposition of a penalty tax on taxpayer for doing exactly that which is urged incessantly by the State and its regulatory body (*i. e.* increasing capital and surplus) seems almost ludicrous. As was stated previously, the accumulated earnings tax is in the nature and character of a penalty and must be cautiously applied and enforced accordingly. This is, simply speaking, not a situation which warrants the imposition of the accumulated earnings tax.

Taxpayer contends that the factors of size, or lack of size, the number of agents or policies, is not the criteria and that a review of the *Alinco* case makes this quite clear. As is generally known, all life insurance companies derive income both from investments and the collection of premiums. Section 801 says nothing about the percentage that the one must bear to the other in order for a company to qualify as a life insurance company. If an insurance company's reserves meet the more than 50% test of Section 801, taxpayer contends that it is a life insurance company. 100% of taxpayer's direct reserves were of the required type. It is submitted, therefore, that taxpayer was and is a life insurance company as defined in Section 801.

Taxpayer contends that one of the most significant cases in this area is *Mutual Fire Insurance Co. of Germantown v. U. S.,* 50 Fed. Supp. 665 (East. Dist. Pa. 1943). The company was a mutual fire insurance company. This was not a case under the federal statutory 50% life reserve test. As a result of wise investments of its earnings the company had developed fairly large investment income, approximately 71% of its total earnings. The government took the position that since its investment income was larger than its premium income, the company was not actually an insurance company. The court held against the government on this point, stating in part:

> "I am of the opinion that the cases cited by the defendant relating to mortgage guaranty and title companies do not apply to a company such as is operated by the plaintiff, which has regularly conducted an insurance business over the years under charter powers which confine its business strictly to an insurance business. The fact that over a period of years plaintiff has accumulated a substantial reserve in the operation of its insurance business, which it has invested and which brings relatively large returns in income as compared with underwriting income, does not in my opinion change the fundamental character of the plaintiff's operations as an insurance company. I, therefore, conclude that plaintiff operated as an insurance company." *Mutual Fire Insurance Co. of Germantown v. U. S., supra.*

The Judge in the foregoing case pointed out that the title insurance cases relied upon by the government were not convincing. (Note same as relied on here by government.) The court held that it was not a question of proportion or percentage of investment income to premium income which was determinative of the taxpayer's right to enjoy treatment as an insurance company. It is significant that in the *Mutual Fire* case 71% of its total income was from investments and 29% from other income. In the present case in the 3 years involved, Industrial Life had more than 50% of premium income and less than 50% net investment income as figured by S. C. Regulation Body. (See Appendix, page 124.) Taxpayer admits, however, that the statute involved, Section 801, does not attempt to require apportionment of investment income nor does it attempt to fix any of the details, with exception to the 50% life reserve test, of whether or not a company is a life insurance company. Taxpayer contends that these details have undoubtedly been left to state regulation. Taxpayer thinks it significant here to note that Section 801 was passed in 1921 and has not been changed by the Congress in the last 52 years so far as the 50% life reserve test the only one the Congress has. Surely if Congress agreed with the government's position that the section needed amending as the regulation implies, it would have done so prior to now. The statute is silent with respect to percentage of income matters or the size of the company, number of agents, and so forth.

The Texas case of *Campbell v. Great National Life Insurance Co.,* 219 Fed. (2d) 693 (5th Cir. 1955) is pertinent to the issue under consideration in the present case. The insurance company in that case had come into possession of certain real property in Texas on which was found oil and the issue in the case was whether or not the oil royalties were interest, dividends or rents under the Internal Revenue statute dealing therewith. The Court held that the oil royalties were neither interest, dividends nor rents and refused to enlarge the statute to encompass all royalties. Taxpayer contends that the Government in the present case is seeking to enlarge the statute in a way similar to their attempt in the *Great National Life Insurance Company, supra.*

Another very convincing case on the side of the taxpayer in the present case is *Van Schaick,* 32 BTA 736 (1935). The question presented there was whether or not an insurance company in the process of liquidation could still be classified as an insurance company for tax purposes. We quote from this case as follows:

> "The question also arises as to whether an insurance company in process of liquidation, as here, is subject to the special provisions of the Revenue Act relating to insurance companies. The taxpayer is an insurance company other than life or mutual. The

> fact that it is being liquidated by the superintendent of insurance for New York and has been in process of liquidation since February, 1921, does not change the character of the corporation. It is, therefore, subject to the tax imposed by Section 204 of the Revenue Act of 1928 on insurance companies other than life or mutual, and its net income is required to be computed under the provisions of that section, the pertinent portions of which are quoted in the margin."

The importance of this case is tremendous in the present situation. The business of the insurance company was not considered as the criteria in determining whether or not it was an insurance company. The insurance company in that case was in the process of liquidation and certainly its premium income during this 14 year stage must have been very insignificant, if any. Apparently the character of the company itself was controlling. Taxpayer contends that in this case the same considerations apply; even though the taxpayer is a small insurance company and had large amounts of income from wise investments made in previous years, it should have no impact upon the decision of whether or not it qualifies for a life insurance company for federal tax purposes, if it meets the terms of Section 801 (the more than the 50% life reserve test) as *Alinco* so held because that is what the Congress said. No more or no less and this taxpayer claims only the Congress itself can levy and collect taxes by Article 1, Sec. 8 of the Federal Constitution.

May we here point out that in the State of South Carolina, the Federal government had no facilities in 1939, the date of the taxpayer's charter, nor any date since that time, to grant a Federal insurance charter in South Carolina. Since the taxpayer was strictly an intrastate operation, no Federal regulation had the power or authority to say that the taxpayer was not an insurance company under the South Carolina law because the South Carolina Insurance Department, a state regulatory agency, under Section 2 (b) of the McCarran-Ferguson Act, had held the taxpayer to be an intrastate life insurance company for thirty-four successive years, and since the *Erie Railroad* case (1938) the Federal court was bound by South Carolina law which had held the taxpayer to be a life insurance company for thirty-four years straight

It is interesting also to note that in a case styled *U. S. v. Home Title Insurance Company,* 285 U. S. 191, that the case arose in New York and was heard in the same year in the same term and decided on the same date and opinion by the same Judge as *Bowers v. Lawyers Mortgage Ins. Company,* 285 U. S. 182 (1932) by Judge Butler and in the brief, the taxpayer there took the same position that this taxpayer is taking in this case; namely, that its total operation was incidental to the insurance business and it was a state matter, not Federal, as to whether or not the taxpayer was an insurance company under state law, because it was a state charter and regulated by state law, and we quote from that case:

> "The fact that the State of New York recognizes and regulates respondent as an insurance company and its business as insurance controls respondent's classification as an insurance company."

It is interesting to note that this brief was filed by the government in 1969. The present case was also under consideration at that time. However, the government takes an exactly opposite view in the present case. Here the government contends that the business is controlling. In the *Drummond-Citizens* case, the government was arguing that it was the reserve test of Section 801 that was controlling. It is hard to understand how the government can take completely opposite views in different cases during the same period of time, and be allowed to get away with it.

II

The District Court's finding that taxpayer held the property for sale to customers in the ordinary course of business is clearly erroneous.

It is undisputed that the Courts have laid down numerous factors for consideration in reaching a decision in these type cases. See *Surrey & Warren, Fed. Inc. Taxation* (1962) P. 691-94 and 34 *Am. Jur.* (2d) *Federal Taxation* (1973) P. 90-96. However, in making a determination of whether real estate has been held primarily for sale in the ordinary course of business or for an investment, no single element is conclusive and each case must rest upon its own facts. (See *Scheuber, supra.*)

The Court based its decision in the present case on the following findings of fact:

14. In 1948 plaintiff bought 504 acres of land in Kershaw County, South Carolina as an investment. Part of this tract has been subdivided into residential lots and the above figures reflect $20,000 in 1963 and $22,000 in 1964 from the sale of such lots. In 1963 the plaintiff by three separate deeds conveyed to Clayton Scyphers eleven lots from this tract. In 1964 by one deed the plaintiff conveyed to Clayton Scyphers eleven lots out of this tract.

15. Prior to 1963 the real estate sales by plaintiff totaled thirteen in 1956, two in 1957, three in 1958, nine in 1959, four in 1960, eight in 1961 and three in 1962. Some of these sales covered more than one lot. Prior to 1963 there were no sales to Clayton Scyphers or members of his family. Prior to beginning the sale of residential lots out of the 504 acre tract, plaintiff obtained permission from the South

Carolina Insurance Commission. On the lots sold to Clayton Seyphers, homes were constructed by him and sold.

16. The real estate, originally purchased as an investment, became property held for sale in the ordinary course of business due to the continued sale and development, and the large part of plaintiff's income resulting from such sale. (App., p. 65.)

Based on the *Malat case, supra*, the ultimate finding must rest on a determination of whether the proceeds of sale are "profits and losses arising from the everyday operation of a business" on the one hand or "the realization of appreciation in value accrued over a substantial period of time" on the other. Taxpayer contends that the latter is clearly applicable to the instant case and the District Court's finding to the contrary is clearly erroneous.

The District Court found that the real estate was purchased as an investment (App. p *65)* but apparently concluded that a change in purpose follows from the subdivision and sale of the property over a number of years. The taxpayer's president testified that he tried to sell the property in one parcel but was unable to consummate a reasonable sale (App. *33).* Surely sub-division and sale by lots a reasonable method of liquidation under such circumstances. The number of sales in the tax years in question amounted to three (3) in 1963 and one (1) in 1964. App. p *65).* This certainly does not indicate that the taxpayer was involved in wholesale real estate sales during the tax years in question. The sales in the years preceding the tax years in question here were insignificant when compared to the sale of *Heller Trust, supra.* In that case 159 duplexes were sold in two years and capital gains treatment was allowed. The fact that Clayton Seyphers constructed homes on the lots he purchased and sold them seems immaterial. It is not his taxes which are of concern in this case.

The fact that permission was obtained from the South Carolina Insurance Commission, likewise, seems to be of small moment. Taxpayer was regulated by the Commission; surely, asking for its permission prior to liquidating an asset would be appropriate.

The impact of the sales income upon taxpayer's income would seem to be totally consistent with the liquidation of a large tract of real estate which has appreciated in value while held as an investment.

The length of time the property was held is always an important factor. *See, Scheuber, supra.* Here taxpayer held the property from 1947 until 1956 before beginning the liquidation sales. Taxpayer contends that this is of extreme importance in the present case. The continuation of sales after the initial sale seems of little importance in light of the *Malat* and *Heller Trust* cases discussed *supra.* If the District Court's reasoning regarding the continuity of sales is adopted it seems hard to imagine how a corporate taxpayer could qualify for capital gains treatment upon the liquidation of an investment asset. As previously stated, in order to liquidate, the property must be held for sale at some point in time just prior to the actual sale.

In addition to the discussion of *Malat, Heller Trust,* and *Scheuber cases, supra,* other Circuit Court cases strongly support taxpayer's contention in the present case. In *U. S. v. Cook,* 270 F. (2d) 725 (8th Cir. 1959), which involved the question of whether taxpayer was entitled to capital gain treatment on pelts from minks culled from a herd, the Eighth Circuit Court said:

> We think the critical period for characterization of the property goes further back than the time of disposition. The property is properly characterized at the time it is acquired for use by the taxpayers in their trade or business and during the period it is so used.

> . . . There is no requirement in the statute that the property be used in the trade or business of the taxpayer right up to and including the date of sale or exchange. The statute contemplates and the regulations provide for a reasonable time for disposition after the necessary termination of the property's intended use. . . .
>
> **If the taxpayer's situation is examined at the very moment the property is sold, it will invariably be found that there was an intent to sell, but such a literal approach would nullify the statutory provisions conferring capital gain or loss treatment, and would seem to go beyond the legislative intent behind the exclusion involved.** *U. S. v. Cook, supra,* P. 729. (Emphasis added.)

In another Eighth Circuit Court case we find the following language:

> . . . we emphasize that the Tax Court in making its findings should not limit its consideration solely to circumstances existing at the time of sale. *Municipal Bond Corp. v. C. I. R.,* 341 F. (2d) 683, 689 (8th Cir. 1965).

On this question of what constitutes a business we find the following language in a Ninth Circuit case:

> Carrying on a business . . . implies an occupational undertaking to which one habitually devotes time, attention, or effort with substantial regularity. **Merely disposing of investment assets at intermittent intervals, without more, is not engaging in business, even though some preliminary effort is necessary to render the asset saleable.** *Austin v. CIR,* 263 F. (2d) 460, 464 (9th Cir. 1959). (Emphasis added.)

Taxpayer contends that this language is precisely applicable to the present case based on the volume and continuity of sales.

On the question of subdivision and individual sales we find the following appropriate language:

> **The Tax Court found as a fact, and we agree, that petitioners bought the property for rental as residential property. Later they decided to sell it in individual sales. That fact points to a liquidation of capital with as much persuasiveness as to sale as a money-makng activity.**

III

The District Court erred in holding that taxpayer was engaged in the sale of lots in the ordinary course of its trade or business during the years 1963 and 1964.

A. The District Court Incorrectly Applied the Law in Reaching its Decision.

IRC Section 1221 (1) excludes from capital assets "property held by the taxpayer **primarily** for sale to customers in the ordinary course of his trade or business." (IRC Sec. 1221—Add. P. 4, emphasis added). This is apparently the code section relied upon by the court in reaching its decision that profit from the sale of lots by taxpayer in 1963 and 1964 were subject to ordinary income tax rates in lieu of capital gains rates. In 1965 no lots were sold so this opinion is bound to be in error for 1965 since this case is based on a year to year basis.

The United States Supreme Court case of *Malat v. Riddell,* 383 U. S. 569 (1966), is a recent and extremely important case interpreting the wording, "property held by taxpayer **primarily** for sale to customers in the ordinary course of his trade or business." In the *Mallet* case the taxpayer was a participant in a joint venture which acquired a 45 acre parcel of land; the intended use for which was in dispute. Taxpayers contended that the intention was to develop and operate an appartment project on the land; the Government took the position that there was a dual purpose of developing the property for rental purposes or selling, whichever proved the most profitable. Difficulties were encountered with the venture and the interior lots of the tract were subdivided and sold. Later, taxpayers sold out their remaining interest in the property and treated the profits from the last sale as capital gains. The Supreme Court was called upon to resolve a conflict among the Circuit Courts with regard to the meaning of the term "primarily" as it is used in § 1221 (1), *supra*. The Supreme Court in a *per curiam* opinion had this to say regarding the interpretation of the statute:

> The purpose of the statutory provision with which we deal is to differentiate between the "profits and losses arising from the everyday operation of a business" on the one handd (*Corn Products Co. v. Commissioner,* 350 U. S. 46, 52) and "the realization of appreciation in value accrued over a substantial period of time" on the other.
>
> (*Commissioner v. Gillette Motor Co.,* 364 U. S. 130, 134.) A literal reading of the statute is consistent with this legislative purpose. We hold that, as used in § 1221 (1), "primarily" means "of first importance" or principally." *Malat v. Riddell, supra.*

Here we see a distinction drawn between profits and losses arising from the everyday operation of a business on the one hand and the realization of appreciation in value accrued over a substantial period of time on the other. Further, the Court states that "primarily" as used in the statute means **of first importance.** (Emphasis added.)

The opinion of the District Court ignores this case completely, even though it is probably the most significant case in this area in years. The District Court omitted the word "primarily" from its findings by merely stating that "the real estate, originally purchased as an investment, became property held for sale in the ordinary course of business." It made no express finding that the property was held "**primarily**" or "of first importance" for sale in the ordinary course of its trade or business, even though the Court found that the property was originally purchased as an investment. Taxpayer contends that if the Court finds that the property is held for two or more purposes, as the District Court did in this case, then a correct application of the *Malat* case, *supra,* requires that there be a finding of which purpose was "of first importance." To ignore language of the statute by simply omitting the word "primarily" amounts to an error of law.

No doubt, the Government will argue that the District Court found that during the tax years in question, taxpayer held the property solely for sale to customers in the ordinary course of its business; the purpose for which it was held at the time of sale is controlling; no dual purpose existed at the time of the sale; and consequently, the word, "primarily" as used in the statute is of no consequence. The District Court asserted this reasoning and cited *Ackerman v. U. S.,* 335 F. (2d) 521 (5th Cir. 1964) and *Bauschard v. CIR,* 279 F. (2d) 115 (6th Cir. 1960) in support thereof. It should be noted, however, that these cases predate *Malat, supra,* and are of little significance in the face of the distinction drawn in *Malat* between ordinary income and capital gains (*i.e.* "profits and losses arising from everyday operation of a business" on the one hand and "the realization of appreciation in value accrued over a substantial period of time" on the other. *Malat, supra.*

Based on the *Malat* decision, the purpose for which the property was held at the time of sale would not be controlling. The District Court found that the property in question was purchased as an investment in 1947. It goes without saying that at some point in time, the property must be held for sale and sold in order to liquidate the investment and reap a profit on the investment. The *Malat* decision makes it clear that the purpose of the sale is "realization of appreciation in value accrued over a substantial period of time," the resulting profits qualify for capital gains tax treatment.

Two post *Malat* Circuit Court decisions are very illustrative of this point. The first case involved the sale of 186 duplexes which had been constructed on property purchased in the latter part of 1949 or early 1950. All of the duplexes were sold during 1955-1958 after rental in earlier years had proved unsuccessful. A more detailed rendition of the facts surrounding the sale follows:

> On September 1, 1955, the six rental corporations were liquidated and 186 duplexes were distributed to the stockholders in liquidation. (The other eight duplexes had been sold between June 1, and August 31, 1955.) The Association served as selling agent for the stockholders and proceeded as rapidly as possible to sell the duplexes. Taxpayer was president of the Association during the years here in issue. Commencing on or about November 1, 1955, the duplexes were advertised for sale. Prior to that the duplexes were advertised only for rent. The Association employed extensive newspaper and radio advertising as part of its selling efforts. The Association moved its office to one of the duplexes, opened a model duplex for display, employed a staff of salesmen to handle the sales and prepared and distributed sales brochures to customers. At the time of the sale of each duplex it was completely reconditioned and redecorated by the Association. In Addition, the Association paid for the closing costs incurred in selling the duplexes. In 1956 taxpayer obtained a real estate broker's license as a designated broker for the Association. Such license had been renewed annually up to the time the Tax Court heard this case. Also, it was shown that taxpayer was a member of the National Board of Realtors and the Tucson Real Estate Board. (It was further estab-

> lished at the time of the trial of this cause below that even after the sales of all the duplexes, the years which are in question here, taxpayer remained active in the general real estate business.)
> *Heller Trust v. CIR,* 382 F. (2d) 675, 679 (9th Cir. 1967).

The Circuit Court quoted at length from the *Malat* case and reversed the Tax Court's holding that the income from the sales should be treated as ordinary income. The Court's reasoning pertinent to the issue under consideration in the present case follows:

> Petitioners argue that the investment property was being liquidated by means of a series of sales and so long as the purpose for selling was liquidation, they should be afforded capital gains treatment on the profits. They maintain that anything may be done to further the liquidation and that if the first sales were interpreted to be in furtherance of a liquidation of property held primarily for investment, all the remaining sales would be insulated so as to afford capital gains treatment.
>
> Under the Tax Court's decisions on this second theory, that is, that the duplexes were held after late 1955 for sale to customers in the ordinary course of taxpayer's business, it would have been impossible for these petitioners to liquidate their interests without having the proceeds therefrom taxes as ordinary income. We do not believe that such a harsh treatment is warranted under the applicable law and the facts of this case. Clearly, up until shortly before the time of the first sales, taxpayer's primary purpose for holding the property was one of investment. If the Tax Court's theory is to be followed, the Court cannot conceive how persons with an investment such as we have here could bring themselves within the purview of the capital gains provisions of the statute where, as here, they had to abandon a disappointing investment by means of a series of sales.

> It is apparent that the Tax Court's second theory is to the effect that once the sales began the taxpayer began to engage in a business. However, where the facts clearly demonstrate that a taxpayer held certain property as an investment, and further show that this purpose continued until shortly before the time of a sale, and that the sale is prompted by a liquidation intent, the taxpayer should not lose the benefits provided for by the capital gain provisions. *Heller Trust, supra.*

Another post *Malat* case lends credence to taxpayer's contention that the *Malat* opinion is contrary to the District Court's opinion in the present case that "the real question is decided by the purpose for which it is being held at the time of sale." Almost identical reasoning was proffered by the Tax Court in *Scheuber v. CIR,* 371 F. (2d) 996 (7th Cir. 1967). In reversing the Tax Court, the Circuit Court discussed *Malat* and its interpretation as follows:

> The U. S. Supreme Court vacated the judgment holding (*Malat*) that the purpose of the statute was to differentiate between the profits and losses arising from everyday operation of a business and the realization of appreciation in value accrued over a substantial period of time. **In seeking to distinguish Malat, the Commissioner stresses the existence of a dual purpose there, viewing the Supreme Court's decision as limited to interpreting "primary" purpose, where there is more than one, as that which is first in order of importance.** Thus the Commissioner contends that the Scheubers had no dual purpose; that they always intended to sell the parcels some time in the future, and that they have shown no effort to demark or isolate these properties from those in their usual inventory.
>
> **We think that this represents a very strained interpretation of Malat and a misapplication of its principles to the facts of this case.** The Malats were also dealers in real estate and operated on a much larger scale than the Scheubers. In *Malat* about 107 pieces

> of unimproved real estate were sold in the taxable year involved. The Commissioner points only to eleven sales and thirteen purchases made by the Scheubers in the several taxable years involved here. The Scheubers held their properties for many times longer periods of time than the Malats. They realized extremely substantial gains over their investments. As a result of the condemnation proceedings, they were ultimately awarded almost $130,000 as the total to be paid for the condemned property, These eventual returns on the amounts initially invested were unrealistically high for items held for resale in day to day operation of a business. As the Tax Court's findings indicate, this real estate was purchased and held for realization of appreciation in value to be accrued over a substantial period of time, with no intensive effort to improve or sell it. It was always intended ultimately to be disposed of to provide the "annuity" of which Mr. Scheuber spoke, but not to be disposed of to customers in the ordinary course of trade. *Scheuber, supra,* P. 999. (Emphasis added.)

Based on the *Malat* case, and the two post *Malat* cases discussed previously, taxpayer contends that the Circuit Court based its findings on an incorrect application of the law. The District Court relied solely on the conduct of taxpayer after the liquidation of the investment property had commenced. The District Court expressed the opinion that the purpose at the time of sale was controlling. This reasoning flies in the fact of the *Malat* principles that (1) "primarily means of first importance" and, (2) "the realization of appreciation in value accrued over a substantial period of time yields capital gains treatment." These tests were apparently completely ignored by the District Court and the 4th Circuit in the present case. Taxpayer is of the opinion that the District Court's approach clearly amounted to an incorrect application of the law, which was approved by the 4th Circuit Court.

INDUSTRIAL LIFE INSURANCE COMPANY
Gaston, South Carolina

July 23, 1973

Clayton Seyphers, President

Circuit Judge Harrison L. Winter
United States Court of Appeals for the Fourth Circuit
c/o Mr. Carol Lemon, Chief Deputy
United States Court of Appeals for the Fourth Circuit
United States Court House
Richmond, Virginia 23219

Re: *Industrial Life Insurance Company v. U. S. A.*
Civil Case No. 72-1693

AMENDED PETITION FOR REVIEW

Dear Judge Winter:

The Congress of the United States, after the famous case of *U. S. v. Southeastern Underwriters* (1944) passed, after long consideration and much debate in many committee hearings, the McCarran-Ferguson Act. 26 Fed. Code (1945) Anno. 15, USCA Sec. 1011-1015. We quote from two of the very important sections:

> " . . . Congress declares that the continued regulation and taxation by the several states of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several states."

> " . . . (n)o act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance." 15 USCA, Sec. 2(b).

In the two cases of *Federal Trade Commission v. National Casualty*, 357 U. S. 560, and *Federal Trade Commission v. Travellers Health Insurance*, 362 U. S. 293, and in the latter case at page 297, the Supreme Court somewhat reviewed these two cases and, after a bitter fight, the Supreme Court interpreted the two above sections of the McCarran-Ferguson Act as meaning that the Congress removed the Federal Court's jurisdiction as to State regulatory matters and let the State regulatory judgment's be final and not subject to review by the Federal Court, and particularly based this judgment on Section 2 (b). See p. 12 for quote.

In the diagram in our original Petition for Review, on the page between 10 and 11, the District Court, rather than read the three large booklets involving the 57th, 58th and 59th reports of the S. C. Insurance Commission to the State Governor and to the State Legislature, on page 110 of the record transcript requested the attorney for the taxpayer to hunt out of these three booklets the State regulatory holdings as to the taxpayer, and we particularly point out that the State in a Certificate on page 9 of the original Petition for Review certified that the examiners of the department have made their regular 3-year on the spot examination of the three annual reports of the taxpayer. So, the Certificate of Mr. John L. Reynolds, Deputy Commissioner, certifies to the summary on the page between 10 and 11 of the State's regulatory judgments, which includes:

1. The admitted assets and unassigned surplus of the company for the three tax years, which all the text books provide that the State has the power to make judgments along this line. See page 6 of original Petition for Review. This authority is not based on the McCarran-Ferguson Act but by common law.

2. The taxpayer reminds the court that the taxpayer is strictly a local domestic intrastate insurance company whose reserves by necessity has to be based on the S. C. Reserve Statutes and that the S. C. Insurance Department, the regulatory agency, made judgment on these reserves which was passing judgment on its own S. C. Statute.

Now, finally, the S. C. Insurance Department, the official regulatory agent, first had allowed the taxpayer to sell some of its lots because it had failed to sell this investment tract as a whole and the fact that it could not sell it as a whole took the next step to sell off some lots (21) during the taxable years until it could dispose of the tract in a different capacity from farm land. It was not the judgment of the taxpayer to so do but was required to do so for the best interest of the insurance company. But Section 56-1545 of the S. C. Code provides that if the owner sells its property that does not make it a real estate operation and we quote:

> "56-1545.2 Chapter Not Applicable to Certain Transactions.—The provisions of this chapter shall not apply to any transaction involving the sale of real estate by anyone who is the owner thereof or who owns any interest therein, or to the attorney at law of such owner acting within the scope of his duties. Ownership of stock in a corporation is not ownership of an interest in real estate owned by the corporation and does not exempt such stockholder from the provisions of this chapter, unless stockholder owns or controls at least ten percent of the stock of the corporation."

We agree that the power of the Federal Government to tax was not delegated to the States but we urge this court with all the power at our command that actually the regulation is not valid as to a life insurance company and we are not interested as to whether or not it was valid as to a no definition of a **insurance company** according to the words of Judge Butler. In fact and in law, we urge this

court that they are allowing an invalid regulation (see page 3 of the original Petition for Review) to enlarge Section 801 and by Section 801 this taxpayer, according to the words of the Congress, should and must prevail unless you enlarge the words of Section 801, and we urge this court not to do it.

We urge this court to require the Government to answer this Amended Petition for Review and set this case down for re-argument because it is a case of great national importance.

Respectfully submitted,

INDUSTRIAL LIFE INSURANCE COMPANY
Clayton Seyphers
Member of Fourth Circuit Court Bar
Post Office Box 74
Gaston, South Carolina

CS:jj

cc: Circuit Judge John D. Butzner, Jr.
Circuit Judge John A. Field, Jr.
Scott P. Crampton, Esquire
Mr. Harry Dent, no longer atty. in this case

PS: The words of section 801 defining a life ins. co. for taxation has one test only for the Federal courts to measure by and tax statutes cannot be changed, enlarged or extended, therefore, if the Congress has not defined a life ins. co. to your court's satisfaction, then it is the Congress' fault and not the court's and the *Alinco* Case expressed it this way: **"Taxation is peculiarly a matter of statutory law, and in applying the law to the determination and computation of income and deductions, the Court does not make moral judgments . . ."**

Again the Court made this very important observation:

"**It is not a matter of conscience but of statute and a determination of congressional intent.** The Government's presentation of its case against **Alinco has been flavored with moral and regulatory overtones.** Such a sensitive concern for good business morals should not be for the Treasury . . ."

See page 8 for sec. 37-281 of the S. C. Code for State regulations in conjunction with the McCarran-Ferguson Act.

Please refer to the Government's position of Mr. Walters in the *Drummonds-Ferguson* Case where Mr. Walters took the exact position that your taxpayer takes here and where Mr. Walters disagrees with the Court's ruling so far.

Clayton Schyphers

We feel that none of these insurers should be permitted to sell new policies to residents of the State unless they meet such requirements within 3 years.

Even if it is the eleventh hour the taxpayer desires to offer the court a new approach in this case which we think will help the court, otherwise, we would not offer it.

It is elementary that if a person or corporation wants to do business in South Carolina or any other state, it or he must agree to be bound by the local state laws. Particularly is this true if the proposed operation to be done is clothed with a public interest such as the practice of law, medicine, or the insurance business; therefore, the Congress realized in the passage of the McCarran-Ferguson Act that the state had the power to regulate the insurance business because it is clothed with a public interest. Therefore, the Congress in 1921, long after the decision of *Paul v. Virginia* (1869) set one standard and one alone as the test of a life insurance company for Federal tax purposes and that was the more than 50% life reserve test, in the present Code section 801. All other regulatory matters were left to state regulation since 1869.

When the Revolutionary War ended, about 50-60 miles below Richmond at York Town, Va. the colonies had been burdened to death by taxation without representation. So, in the early portion of the Federal Constitution, in Article I, Section 8, the Constitution provides that only the Congress can lay and collect taxes. Therefore, every Federal taxpayer in the U. S. is tremendously interested in this case because Section 801 is plain, simple, and unambiguous. Since the sole purpose of any regulation is to simplify and make clear the technical language of the Statute, in this case there is no reason or justification for Federal Regulation 1-801-3 (a), and we quote Volume 1 of Mertens Construction of Tax Statutes, Section 3.25 which defines when a Regulation can be valid, binding and effective, and when it cannot be valid, binding and effective, and we quote:

> " . . . It merely clarified what the language of the statute always was intended to convey. It does not, and could not alter the statute . . ."

In the case at court, the Regulation cannot be effective according to the terms of Mertens, and is therefore void and of no effect. We support Mertens ruling by citing *Service Life Insurance Company v. U. S.*, 293 F. (2d) 72 (1961) at p. 77: (2 Cir.)

> (2) " . . . Since the ruling clearly contravened the law, it was without legal effect. It is elementary that revenue rulings and even Treasury Regulations are without force if they are in conflict with the statute. *Boykin v. Commissioner of Internal Revenue,* 8 Cir., 260 F. (2d) 249, 254."

Therefore, in fact and in truth the Government, basically and fundamentally, is attacking the famous separation of powers in our form of government in that they do not want the Congress to lay and collect taxes but seeks to have the Secretary of the Treasury which is a branch of the Executive department and not the Congress to not only lay and collect taxes by Federal regulation 1.801-3 (a) but the District Court provided that the regulation, even though it was contrary to the words, intent, and spirit of the Congress in Sec. 801 defining a life insurance company. We quote from the District Court which held contrary to the *Alinco* court:

> **"Before a company may be classified under the above section as a life insurance company, it is necessary to determine if it is an insurance company, since this is the first requirement mentioned. The Internal Revenue Code does not define the term 'insurance company', but Treasury Regulations on Income Tax (1954 Code), Section 1.801.3(a) provides:"**

And then the court proceeded to quote Federal regulation 1.801-3 (a) as the court's justification for his holding, which regulation does not even mention the more than 50% life reserve test, the only test in Sec. 801, but sets up two new and different tests — "primary and predominant." So, the regulation does change Sec. 801. And enlarge it. Lastly, when you carefully analyze what the government asked this court to hold, it is in fact asking us to hold that the Constitution itself is improperly written and that the writers of the Constitution really did not mean what they said in Article I, Sec. 8.

The District Court in our judgment improperly keyed this case the *Bowers* case because the *Bowers* case was keyed to the two words "insurance company", and the *Bowers* decision came down six years before the *Eric Railroad* case when the Federal court still had the power to write federal substitive law. But the case at bar is not keyed to the *Bowers* case or to the isolated words "insurance com-

pany" because here this case turns on Federal Code Statute 801 which gives a complete and detailed unambiguous definition of a life insurance company. And, by reason of the McCarran law this case turns on State law, and the South Carolina regulatory agency had held the taxpayer, under state law, to be a life insurance company for 34 years. Alinco quickly recognized the problem that the government was insisting on in Alinco; namely, moral and regulatory law, which flatly turned down the Government, and we quote from Alinco, where Alinco refused to use Federal regulation 1.801-3(a):

> " . . . The Government's presentation of its case against Alinco has been flavored with moral and regulatory overtones . . . Alinco asked only that it be taxed like other life insurance companies. In any judgment it is entitled to be so taxed provided only that it can meet the technical statutory requirements set forth as such in 801 of the Code . . . "

The district court held that the question of the insurance company which is the basis of the federal regulation was the first and principal question involved which is contrary to the holding of Alinco.

In the *Alinco* case, the court agreed with this taxpayer but did not agree with the District Court which reversed Alinco's holding, the most important case of our time, and which dedicated itself to defining a life insurance company under Section 801 of the Code:

> " . . . The principal question, therefore, is not whether Alinco was an insurance company but whether it was a life insurance company under the technical qualification formula contained in Section 801."

And in another part of the decision it said:

> " . . . (thus it was the character of an insurance company's business as measured by its policy reserves

that served as the touchstone for the definition of 'life insurance company'.")

The court below totally misconceived, misunderstood, and misplaced the taxpayer's contention. The Court of Claims made the following statement which is a true interpretation of the case at bar and we quote: (see Alinco)

> " . . . It is not a matter of conscience but of statute and a determination of congressional intent . . . "

After the Court of Claims flatly turned down the government's contention involving moral and Federal regulatory contention or overtones, the Court of Claims used these words:

> ". . . . Alinco asked only that it be taxed like other life insurance companies. 'In my judgment it is entitled to be so taxed provided only that it can meet the technical statutory requirements set forth as such in 801 of the Code. . . .' "

Also, the Court of Claims used these words:

> ". . . thus it was the character of an insurance company's business as measured by its policy reserves that served as the touchstone for the definition of 'life insurance company'."

Again we quote from Alinco: (1969)

> ". . . The principal question, therefore, is not whether Alinco was an **insurance company** but whether it was a **life insurance company** under the technical qualification formula, contained in Section 801."

In the *Arkansas* case, Mr. Walters was forced to take the position he took or try to get the court to reverse Alinco, as this court has done.

Mr. Johnnie Walters sensed that the Federal regulation 1.801-3(a) interpreting **'insurance company'** as used by Judge Butler in the *Bowers* case was not applicable to a life insurance company case as contended by the Drummonds Citizens Insurance Company as a so-called preliminary test,

because Judge Butler was confronted with insurance company as applied to a title insurance company. But here the court is confronted with a life insurance company completely defined since 1921 and has one test only; namely, the more than 50% life reserve test and the cases before and the cases after the McCarran Act all hold that is the sole test. And, that District Judge Robert Chapman totally misapplied taxpayer's contention and used Federal regulation instead of Mr. Walters' contention in the Drummonds Citizens brief: (Now we quote Mr. Walters' brief) (1969)

> **"Rather the statutory language is explicit in providing that, for purposes of federal income taxes, the term 'life insurance company' means a company which sells life insurance if its reserves meet certain prescribed requirments."** (Our Note — meaning Section 801.)

And on page 13 and 14 of that same Government brief, we quote again:

> **"In 1942, the statute was changed so that only reserves which qualified for the computational sections could also be considered as life insurance reserves for the preliminary purpose of qualifying the company as a life insurance company.** See Section 163 of the Revenue Act of 1942, c. 619, 56 Stat. 798. That statutory scheme has been carried forward to the 1954 Code."
>
> **"Thus, Congress has deliberately provided that it is the company's reserves (and not its business, as taxpayer contends) which determine whether the company is a life insurance company for federal income tax purposes.** Hence, it was necessary in *Alinco Life Insurance Company v. United States,* 373 F. (2d) 336 (dt. Cl., 1967), for the Court to analyze Alinco's reserves to determine whether it would qualify as a life insurance company within the terms of Section 801 (a) of the Code in spite of the fact that Alinco's sole business activity was the reinsurance of life insurance policies. If

taxpayer's position herein were correct, Alinco would have qualified automatically regardless of its reserves."

But the District Court in this case held it was the company's business and not its reserves; otherwise the taxpayer would have prevailed.

For the intent of Congress we cite the words of Mr. Chairman, Wilbur Mills in the debates of February 18, 1959 Vol. 105 Cong. Rec. 1.2576-2577

> **". . . We are trying to preserve as best we can in this bill the management of this industry in the hands of the state regulatory agencies and not to change in any way that situation so as to turn over to the Commissioner of Internal Revenue, the Secretary of the Treasury, or anyone else in Washington in regulatory authority. . . ."**

AFFIDAVIT OF COMPLIANCE

STATE OF South Carolina Personally appeared Clayton Scyphers who being duly sworn, says he is the President of the Industrial Life Insurance Company has not violated any of the laws of the State of South Carolina and that it accepts the terms and obligations imposed by the laws of this State as a part of the consideration for the issuance to it by the Chief Insurance Commissioner of said State of a license to do business in said State.

....

Sworn to before me this the 25th day of June, 1973.

.... (SEAL.

My Commission expires ——————————

If any insurance company, big or small local or foreign wants to do a life insurance business in South Carolina it must first make application in South Carolina for admittance to do business and agree in writing to be bound by the S. C. Insurance Law. Then if it sells insurance in S. C. its agents must first be licensed in S. C. and be bound by the S. C. Law and its policies that are issued must be based on the S. C. Reserve Statutes and its assets in whatever form they are unimproved land, bonds, stocks, etc., the company must agree that they are to be regulated and evaluated by the S. C. Insurance Dept., therefore, it is obvious why the Congress provided for state regulation and that the sole test of life insurance company for Sec. 801 and it has not been changed or amended since 1921 and in effect the government is asking this court to amend and enlarge Sec 801.

A close look at the three year summary on the next page of this proposed order which is a summary of Exhibits 12, 13, and 14 on page 111 of the record shows the regulatory function of the S. C. Insurance Department and showing the various phases of what it passed judgment upon, and particularly the certificate of the insurance department dated June 28, 1971, and signed by John L. Reynolds, Deputy Commissioner where he certified that the department had approved our reports for 1963, 1964, and 1965, and a $30.00 error in 1966 which was beyond the tax years approved our reports for 1963, 1964, and 1965, and only a $30.00 error was found in 1966, which year (1966) was after the tax years in question. He also certified that the department had examined the company in 1963 and 1966, which is required by law in S. C., every three years. So the summary as prepared by Mr. Lightsey not only represents our report but the fact that it had been examined by the accountants or auditors and actuaries by the State for the three years in question. This taxpayer does not understand the ethics of the Government in repudiating these three examinations, neither do we understand the government's position in the case at bar and the Cardinal Life case, 300 F. Supp. 337 (1969).

The court cannot overlook the fact that the S. C. Insurance Commission itself has requested the S. C. Insurance Legislative Study Committee to introduce and pass legislation which would abolish the "grandfather clause," therefore, this court holds that this is complete justification for the taxpayer's accumulation of assets as it has done.

It is most important that this court compare the holding of the insurance department as is analyzed on this page by Mr. Lightsey at the request of the Judge, which figures were extracted by Mr. Lightsey from the official 57th, 58th, and 59th annual reports of the insurance department. We made particular reference to the net investment income of the insurance department as contracted to the holdings of the District Judge which is much greater because the Judge did not analyze cost, maintenance, overhead, etc., but here these figures are official state records. The insurance department said in its 57th, 58th and 59th annual reports, which reports are official binding S. C. regulatory judgments, that the taxpayer's total net investment income for the three tax years was $28,365.61; yet the court figured its net income was four times this amount, or $95,752.26, and the court was bound by S. C. official judgment which it refused to abide by.

State Of South Carolina

DEPARTMENT OF INSURANCE
Federal Land Bank Building—1401 Hampton Street
Columbia, South Carolina 29201
June 28, 1971

CERTIFICATE

During the years 1963, 1964 and 1965, the Reserves were required by law in South Carolina on Life Insurance. This Reserve was calculated basically on a mortality base.

The examiners of this Department have examined the records for the Industrial Life Insurance Company for 1963 and 1966. For the year 1963, the examiner's Reserve calculations agreed with those of the Company; and in 1966, the examiners increased the Company's Reported Reserve by $30.00.

This Department has accepted the Reserve figures as reported by the Company for the years 1964 and 1955.

The Reserves reported by the Company and examined and/or accepted by the Department were Reserves on Life Policies and Contracts only.

John L. Reynolds,
Deputy Commissioner, Administration

TAXPAYER'S NOTE: This statement was inadvertently left on the Judge's desk by the Judge, and he issued a special order that this statement be a part of the official record as sent to Richmond. The truth in the matter is that this statement by the Insurance Department and their three annual reports show that we had policies in force, reserves calculated, and assets to meet the reserves, and this is all the taxpayer needed under Section 801.

On page 26 of the Record Transcript and classified as Exhibit No. 6 the taxpayer issued one group credit life insurance policy dated 3-1-62 and from which policy the Consumer Investment Company issued certificate of insurance to each creditor. It will be noted from the financial summary that 1963 we insured 274,960 dollars. In 1964 we had outstanding $299,864.00 and 1965 we had an exposure with the consumer investment company of $342,392.00, or an average of $305,000.00 per year. And each policy averaged somewhere from $200.00 to $250.00 dollars. At $200.00 there would have been 1,500 individual policies, or at an average of $250.00 per policy it would have been 1,200 individual risks, which were scattered all over South Carolina. In addition, the company had a total of $20,000.00 in life exposure on its officials, in 1965. It had $10,000.00 total exposure in 1964, and $5,000.00 total exposure in 1963. And in addition, it had approx. 1,800 individual industrial Life policies which were being carried by two different companies. Two subcontractor reinsurance companies which South Carolina policyholders had not released the taxpayer or no novation. See exhibit 3 and exhibit 5 on pages 21 and 25, of the record transcript. And we call the Court's attention that the S. C. Insurance Department had made its regular 3 year required audit in 1963 and 1966 which covered the assets, the reserves, the premium income, the investment income and the actual life exposure for these three years.

It is true that the lower court held that the Government did not give up the right to tax the taxpayer by the passage of the McCarran-Ferguson Act, and this we do not question. But we also contend that the passage of the McCarran Act did not change or enlarge Section 801 of the Federal Code defining a life insurance company. The taxpayer also contends that only the Congress itself has the right and power to change or amend Section 801 defining a life insurance company which the Congress has not done during the last 52 years.

The taxpayer desires to point out that the McCarran Act came into existence solely because the Congress was unhappy by the Atlanta decision of the now famous case of *U. S. vs. Southeastern Underwriters* and actually the McCarran-Ferguson Act for all intents and purposes reinstated *Paul vs. Virginia,* so far as management control and regulation is concerned of the insurance industry. If the government is sincere in its insistance on federal regulation 1.801-3(A) it should go straight to the Congress and have the Congress change section 801 who are the only ones that

have the power to amend or write a new tax act by article 1 section 8 of the federal constitution and regardless of what the district court thought or anyone else, it is the duty of the Congress to change the statute 801 and not the court.

And we quote from *Securities and Exchange Commission v. National Securities, Inc.,* 89 S. Ct. 564 (1969).

> "... **In context, however, it is relatively clear what problems Congress was dealing with. Under the reign of** *Paul v. Virginia, supra,* **states had a free hand in regulating the dealings between insurers and their policyholders.** Their negotiations, and the contract which resulted, were not considered commerce and were therefore left to state regulation. The Southeastern Underwriters decision threatened the continued supremacy of the states in this area. **The McCarran-Ferguson Act was an attempt to turn back the clock, to assure that the activities of insurance companies in dealing with their policyholders would remain subject to state regulation."**

Therefore the taxpayer earnestly insists that when the Court on record transcript page 110 asked Mr. Lightsey to prepare this financial summary from Exhibit 12, 13 and 14 on page 111 of the record transcript that the defendent proved the plaintiff's case then and there, particularly after the testimony of Mr. Gilbert Trapp, the writing agent.

Therefore, this court has the opinion of the most famous case of our time and the brief of the Federal Government in the *Drummonds-Citizens Insurance Company* case as prepared and signed by the Honorable Johnny Walters, then Assistant Attorney General of the United States and then Chief Tax Counsel for the United States who took the position then (1969) that this taxpayer now takes against this situation the court has the *Cardinal Life Insurance Company versus United States* cited as 300 F. Supp. 387 (1969) and followed by the lower court in this case. In addition, the government by letter dated July 7, 1970 addressed to the taxpayer cited a reference or opinion from the Internal Revenue Service in Washington, and we quote:

> "The issue presented is whether the taxpayer is a life insurance company within the meaning of section 801 (a) of the Code for the taxable years under examination.
>
> **Section 801 (a) of the Code provides in part and in substance that for purposes of subtitle A of the Code, a life insurance company is an insurance company which is engaged in the business of issuing life insurance and annuity contracts "if — (1) its life insurance reserves . . . comprise more than 50 percent of its total reserves . . . ."**
>
> **Under the facts presented, the taxpayer would clearly meet the reserve requirements of section 801 (a) of the Code for purposes of qualifying as a life insurance company, and accordingly, would be a life insurance company under that Code provision if it first qualifies as an "insurance company." The "insurance company" question is, therefore, the real question to be resolved here. In this regard, section 1.801-3(a) (1) of the income Tax Regulations provides:"**

The Federal Regulation 1.801-3 (a) actually originated from *Bowers v. Lawyers Mortgage Company*, 285 U. S. 182 (1932) where Judge Butler in 1932 was discussing the words 'insurance companies' with no definition, which was six years before the *Erie Railroad* case, and Judge Butler was confronted with not a life insurance company case but with a title insurance company case used these words:

> "The act does not define 'insurance company' or definitely indicate criteria by which corporations meant to be so specially dealt with may with certainty be identified."

But, in Alinco the court there was defining life insurance company under Federal Code Section 801, which sta-

tute was plain and unambiguous and did not need the aid or help of Federal regulation 1.801-3 (a), and the Alinco court then used these words:

> ". . . The principal question, therefore, is not whether Alinco was an **insurance company** but whether it was a life insurance company under the technical qualification formula contained in Section 801."

Again this court is bound to point out that Section 801 has one test and only one test, namely, the more than 50% life reserve test. So Mertens supports or in effect codifies what Section 801 had to say, and we quote Volume 8 of Mertens Insurance Tax Law, Sec. 4426, 1971 Supplement:

> **"In this manner Congress has left it to the states to determine the amount of funds which must be reserved by insurance companies to provide for the various obligations assumed under the many different types of policies which may be issued under the laws of the different states."**

As we see this case, even though related issues of this type have been to the Supreme Court five times, we cannot perceive any one of these five cases being of any greater national importance than this case, so far as the interpretation of Section 801 is concerned. For this reason, we beg this court to consider this Memorandum—a copy of which is being sent to all proper parties.

The taxpayer urgently contends that any time the lower court used any standards or measuring rods other than the more than 50% life reserve test which are the words of Section 801, then the lower court unfairly enlarged the federal code defining a life insurance company and are being unfair to the taxpayer and the Congress and therefore this case should be reversed. Also, when the full S. C. Insurance commission urges in writing the S. C. Legislature Study Committee to wipe out the "Grandfather" clause, this is good reason to justify the taxpayer in its accumulation of assets and therefore, the lower court's judgment involving Section 531 should also be reversed.

Respectfully submitted,
INDUSTRIAL LIFE INSURANCE COMPANY
Clayton Scyphers

UNITED STATES COURT OF APPEALS
Fourth Circuit
August 15, 1973

Mr. Clayton Schyphers
P. O. Box 74 Gaston, S. C. 29053

Re: No. 72-1693 *Industrial Life Insurance Company v. United States of America*

Dear Mr. Schyphers:

In response to your letter of August 9, 1973, your time to petition the Supreme Court for a writ of certiorari commenced on July 27, 1973.

This is the date your petition for rehearing was denied.

If I can be of any further assistance to you, please do not hesitate to contact me.

Sincerely yours,
WILLIAM K. SLATE, II, CLERK,
By RUSSELL W. RILEY,
Russell W. Riley,
Senior Deputy Clerk.

ssg

CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that service of the foregoing Application for a Writ of *Certiorari* has this 22 day of October, 1973, been made on counsel for defendant by depositing a copy thereof, postage prepaid, in the United States mail.

CLAYTON SCYPHERS,
P. O. Box 74,
Gaston, S. C.

TAXPAYER'S NOTE:

Since, by the Clerk's letter, the 90-day time for Writ of Certiorari to be filed, according to our calculations, expires on October 25, 1973, we will have it filed by that date.

Yours truly,

INDUSTRIAL LIFE INSURANCE COMPANY

By: CLAYTON SCYPHERS,
Clayton Schyphers,
Member, Fourth Circuit Court Bar.

In brief summary, taxpayer contends that its income during a particular year has no significant relationship to whether it should be classified as a life insurance company for income tax purposes. Taxpayer contends that its activity and its classification under the state laws over the last 34 years should be the criteria and not an income percentage for a certain year.

Even if the Court should find that Regulation 1.801-3(a) (1) is a valid regulation for § 801, taxpayer contends that it qualifies as a life insurance company thereunder since its primary and predominent business activity during the taxable years in question was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. The Statute 801 nor the regulation says nothing about income percentages and merely states that the company's primary and predominent business activity must be that of insurance. Taxpayer contends that its business activity during the tax years in question without a doubt complies with this requirement, especially since this is strictly a State of S. C. intrastate insurance company and since the Charter provides for investments in real estate, and since the State regulatory agency authorized the taxpayer to begin to liquidate this large piece of property by the sale of lots, and the District Court recognized this authority by the State insurance department in Findings of Fact No. 15.

In the present case, the taxpayer offered evidence that it had approximately 1,200 credit life risks outstanding during the tax years in question. In addition the taxpayer was obligated under several keyman life insurance policies and under several industrial life insurance policies with members of its president's family. The taxpayer contends that this business was its predominant business during the tax years in question and that based on this business it qualified under § 801 of the Internal Revenue Code.

Here we call attention to the fact that the McCarran-Ferguson Act regulates the insurance business—since 1945. That the Section 801 defining a life insurance company under the Federal law nor any section of the McCarran-Ferguson Act does not give the Federal government the power to say what kind of policies the taxpayer shall write, which is strictly a matter for state regulation, and the state approved without dissent our so-called key man insurance. In fact, they approved all the policies the taxpayer had.

However, in addition to the foregoing, out of the approximately 25,000 insurance policies which had been reinsured by the taxpayer in previous years, there were approximately 1,800 of these policies still in force during the tax years in question. It is taxpayer's position that it was still liable on these risks because the original policies issued and signed by taxpayer were still in the hands of the South Caorlina policyholders and the policyholders had never agreed and there was no novation, meaning that they had never agreed to accept present reinsuring carriers. It is the contention of the taxpayer that regardless of the words of the reinsuring contracts, the present carrier are

nothing more than subcontractors and the taxpayer remains principally liable on these policies.

One of the simplest statements along this line is to be found in the case of *Empire Insurance Company v. Landman,* 104 S. 425:

> **Insurer could not, without policyholders' knowledge or consent, make contract of insurance which abrigated rights of insured against original insurer.**

Along these lines, it is interesting, also, to note that the Federal Government tried to cancel some of its group of servicemen's insurance after one of our wars. The issue came before the Courts in the case of *Lynch v. U. S.,* 292 U. S. 57 1934. The Court refused to let the Government cancel the contracts:

> The Fifth Amendment commands that property be not taken without making just compensation. Valid contracts are property, whether the obligor be a private individual, a municipality, a state, or the United States. Rights against the United States arising out of a contract with it are protected by the Fifth Amendment . . . When the United States entered into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals. That the contracts of war risk insurance were valid when made is not questioned. As Congress had the power to authorize the Bureau of War Risk Insurance to issue them, the due process clause prohibits the United States from annulling them, unless, indeed, the action taken falls within the Federal police power or some other paramount power, is a reasonable doubt as to the meaning of a taxing act, it should be construed most favorably to the taxpayer. *Swift & Company v. U. S.,* 151 F. (2d) 625, 627 (   ).

Such is the general law and such is the South Carolina law, as seen from the case of *S. C. & G. v. Pinckney*, 60 S. E. (2d) 851, 854:

> Our conclusion is strengthened by the well-settled rule that tax statutes cannot be extended by implication beyond the clear import of the language used and any substantial doubt must be resolved against the Government and in favor of the taxpayer.

Out of the 1,800 reinsured policies still on the books and still being collected by the subcontractors or insurance companies as the taxpayer's agents, we call the court's attention that some 800 of these 1,800 weekly premium policies were A. & H. non-cancellable policies and these policies' reserves all met the life reserve test by S. C. law, but under the Fedral law, no reserves are required to be a life insurance company under the Fedral law on A & H. weekly premium non-cancellable policies. Apparently, the one exception to the 50% rule. So, since this litigation involved Section 801 of the Federal Code and not the State law, undoubtedly these some 800 policies standing alone as such should require this court to hold with the taxpayer, since Code Section 801 requires no reserves as to these 800 policies under the following Code Section. Here the government can have no answer.

Section 801(b)(2)(a), and we quote:

> "Reserves Must Be Required by law. — Except — (A) in the case of policies covering life, health, and accident insurance combined in one policy ssued on the weekly premium payment plan, continuing for life and not subject to cancellation. ****"

The effect of which is this: That a company can be a huge life insurance company writing weekly premium A. & H. non-cancellable policies and still be a life insurance company under the Federal law because Section 801 bases its only test on reserves, and under the Federal law in this case, approximately 800 of these policies were still on the taxpayer's risks, and no reserves are required by Federal law, and the fact that they have been collected by the subcontractor since 1947, and since 1953 is of no consequence. See Van Schaick, 32 B. T. A. 736 (1935), plus, the 1,200 credit life policies of C.I.C. Corporation is overwhelmingly in favor of the taxpayer.

In conclusion, taxpayer contends that the wording of the regulation in question here goes beyond and is contrary to the unambiguous wording of § 801. The 50 per cent test of § 801 is the controlling factor as far as Federal income taxes are concerned. The question of what is or is not an insurance company for other purposes must be left to the control of the various state governments.

Even if the regulation were proper, taxpayer's primary and predominent business activity during the taxable years in question was that of the insurance business. If there is any doubt, it should be resolved in favor of the taxpayer. The lower Court's findings to the contrary are clearly erroneous and should, therefore be reversed.

In summary, taxpayer would reiterate the following:

(1) In the aftermath of the *Southeastern Underwriters* case which seemed to cut at the foundation of *Paul v. Virginia,* Congress reaffirmed the holding of *Paul v. Virginia* by passage of the McCarran Act. The McCarran Act in no uncertain terms expressly delegated the regulatory authority to the states in matters concerning insurance companies.

(2) Taxpayer in this case is a wholly intrastate business and is therefore not subject to Federal regulations. States promulgate their own laws and regulations with respect to intrastate business.

*(3) The Government brief in the *Drummond Citizens* case recognized and so stated that it was the reserve test

and not the business that was controlling under IRC § 801.

(4) The *Alinco* case pointed out that the Government's argument was based on moral and regulatory overtones. The Court flatly rejected such arguments in favor of a technical statutory application of Section 801.

(5) Because Sec. 801, by the Congress in defining a life insurance company, has one test and one test alone; namely, the more than 50% life reserve test; no more, no less.

(6) The McCarran Act, nor any other Act since 1921, the date of its predecessor, Sec. 801, has attempted in any way to change or enlarge the 50% life reserve test.

So the real and only test here is does this taxpayer maintain the more than 50% life reserve test. The Federal government in the IRS letter from Washington to the IRS in Columbia, in a letter dated July 7, 1969, addressed to the taxpayer from Washington, D. C., IRS, and we quote from this letter:

> "The issue presented is whether the taxpayer is a life insurance company within the meaning of section 801 (a) of the Code for the taxable years under examination.
>
> Section 801 (a) of the Code provides in part and in substance that for the purposes of subtitle A of the Code, a life insurance company is an insurance company which is engaged in the business of issuing life insurance and annuity contracts "if— (1) its life insurance reserves . . . comprise more than 50 per cent of its total reserves. . . ."
>
> Under the facts presented, the taxpayer would clearly meet the reserve requirements of section 801 (a) of the Code for purposes of qualifying as a life insurance company, and accordingly, would be a life insurance company under that Code provision if it first qualifies as an "insurance company." The "insurance company" question is, therefore, the real question to be resolved here. In this regard, Section 1.801-3 (a) (1) of the income Tax Regulations provides:" . . . .

Finally, we quote from the *Alinco Life Insurance Company* case, the most important lower court case of our time, where the court of claims in Washington disagreed:

> ". . . The principal question, therefore, is not whether Alinco was an insurance company but whether it was a life insurance company under the technical qualification formula, contained in Section 801."

Again, we call the court's attention to John Reynolds', S. C. Deputy Insurance Commissioner, statement, and which Certificate of John Reynolds and his testimony certified that during the three years they had examined the taxpayer and had approved his reserves and every single operation yet the then Commissioner who was Assistant U. S. Attorney in Columbia at the time of trial came back and sought to repudiate his own departmental judgments which were final judgments as certified by the 57th, 58th and 59th reports to the Governor and Legislature which we say is binding on the Federal court in this case.

In the District Courts' Findings of Fact No. 15, the Court's own judgment flies in the face in the terms of his own Federal regulation that the court relied upon 1.801-3 (a) which held the business is limited to a year-to-year basis and by its own terms cannot go beyond the three tax years in question, yet in Findings of Fact No. 15, the Court goes back to 1956, eight years before the commencement of this tax action, and in 1965, there were no sales of lots; yet the court held the taxpayer not to qualify in 1965 as a life insurance company, all of which is unbelievable.

The real question is — can the Court in this case enlarge Section 801 in the finding by the Secretary of the Treasury where the Secretary by regulation 1.801-3 (a) (1) does not even mention the single test as laid down by the Congress; namely, the more than 50% life reserve test, but instead used primary and predominant which grew out of a Title Insurance Company case where according to Judge Butler, the Statute did not even define what a Title insurance company is, but in this case, we are dealing with a life insurance definition which is completely defined and there is no reason for a regulation, and we quote from Bowers, where Bowers used these words:

> "The act does not define 'insurance company' or definitely indicate criteria by which corporations meant to be so specially dealt with may with certainty be identified."

Since the sole purpose of any regulation is to simplify and make clear the technical language of the Statute, in this case there is no reason or justification for Federal Regulation 1.801-3 (a), and we quote Volume 1 of Mertens Construction of Tax Statutes, Section 3.25 which defines when a Regulation can be valid, binding, and effective, and when it cannot be valid, binding, and effective, and we quote:

> ". . . It merely clarified what the language of the statute always was intended to convey. **It does not, and could not alter the statute. . . .**"

In the case at court, the Regulation cannot be effective according to the terms of Mertens, and is therefore void and of no effect. We support Mertens ruling by citing *Service Life Insurance Company v. U. S.*, 293 F. (2d) 72 (1961) at p. 77: (2 Cir.)

> (2) ". . . Since the ruling clearly contravened the law, it was without legal effect. It is elementary that revenue rulings and even Treasury Regulations are without force if they are in conflict with the statute. *Boykin*

v. Commissioner of Internal Revenue, 8 Cir., 260 F. (2d) 249, 254."

Respectfully submitted,

INDUSTRIAL LIFE INSURANCE COMPANY,

By: CLAYTON SCYPHERS,
P. O. Box 74,
Member of Fourth Circuit Court
of Appeals Bar.

APPENDIX

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APPENDIX

INDUSTRIAL LIFE INSURANCE COMPANY

Columbia, South Carolina

(Hereafter Called the Company)

Number — 3162

Creditor — CONSUMER INVESTMENT COMPANY, INC.

$1.00 (One dollar per thousand $1,000.00) per month.

(Eighty-Two Cents per $1000.00) per month.

Premium $ .82 per month per $1,000.00 Life Insurance

Premium — $

Due Date — March 1, 1962 and on the First day of each month thereafter.

Limits — Maximum Age 65;

Maximum Amount — $2,000.00 per Debtor Insured.

Issue Date — March 1, 1962

Master Group Credit Life Insurance Policy

DEATH BENEFIT — If any insured Debtor shall die while this policy is in force, the Company shall pay to the Creditor the amount of insurance for which the Debtor is covered, which payment shall be applied to reduce the indebtedness of the debtor.

INSURED DEBTOR — A Debtor of the Creditor shall become insured automatically on the first day on or after the Issue Date of this policy on which he is indebted to the Creditor, except as follows:

(a) When the Debtor is a partnership, association or corporation, or

(b) When the indebtedness is repayable over a period exceeding 36 months,

(c) Only one person shall be insured with respect to any one indebtedness. When the loan or purchase agreement is executed by two or more persons, the

Debtor insured under this policy shall be the person whose signature appears first unless the Creditor, at the time the insurance becomes effective, designates one of the other persons executing the loan or purchase agreement as the Debtor insured under this policy.

AMOUNT OF INSURANCE — The amount of insurance on any insured Debtor at any time shall be the amount of his indebtedness to the Creditor subject to the above Limits.

CONSIDERATION — This policy is issued in consideration of the application herefor a copy of which is attached hereto and made a part hereof, and the payment in advance of the premiums as stated herein.

POLICY PROVISIONS — This policy is effective on the Issue Date and accepted subject to all of the conditions and provisions set forth on this and the following pages, all of which are hereby made a part of this contract.

IN WITNESS WHEREOF the *Industrial life Ins. Com.* has executed this policy at its Home Office, in Columbia, South Carolina, on the Issue Date.

CLAYTON SCYPHERS,
President

A. L. Scyphers
Secretary

Policy Provisions

PAYMENT OF PREMIUMS — All premiums shall be paid by the Creditor at the Home Office of the Company as stated above. Each premium shall be equal to the product of the total amount of insured indebtedness on all Debtors to be covered hereunder as of the due date of such premium and the monthly premium stated above.

GRACE PERIOD — A grace period of 31 days, without interest charge, shall be allowed for the payment of each premium after the first premium and the policy shall be in force during such period. If any premium shall not be paid within the grace period, this policy shall terminate at the end of such period, in which case the Creditor shall be liable to the Company for the payment of the premium for such grace period.

ERROR IN AGE — If the age of any Debtor shall exceed the maximum stated above at the time said Debtor became indebted to the Creditor, the Company shall be liable only for the return of premiums paid on his behalf.

TERMINATION OF POLICY — Either the Company or the Creditor may cancel this policy upon 31 days written notice to the other party.

TERMINATION OF INDIVIDUAL INSURANCE — The insurance on a Debtor shall terminate automatically if any of the following shall occur:

(a) Discharge of the indebtedness, or
(b) Attaining the Maximum Age Limit stated above, or
(c) Transfer of the indebtedness to another Creditor not covered hereunder, or
(d) Termination of this policy, or
(e) Repossession of the property, if any, upon which the indebtedness was based, or
(f) Entry of judgment in any court with respect to the indebtedness.

RECORDS — The Creditor shall furnish the Company at the beginning of each month with the total amount of indebtedness outstanding. The Company shall have the right to examine such records of the Creditor as pertain to this business at any time to verify the total outstanding insurance or to verify the amount of insurance in force on the life of any individual Debtor.

INCONTESTABILITY — This policy shall be incontestable, except for non-payment of premiums, after one year from its Issue Date.

AMENDMENT OF POLICY — This policy may be amended at any time, without the consent of the Debtors insured hereunder, upon written request made by the Creditor and agreed to by the Company, but any such amendment shall be without prejudice to any claim arising prior to the date to which premiums shall have been paid. No agent is

authorized to amend or alter this Policy, to waive any conditions or restrictions contained herein, to extend the time for paying premiums, or to bind the Company by making any promise or representation or by giving or receiving any information. No change in this Policy shall be valid unless evidenced by an endorsement hereon, signed by the President, a Vice-President, or the Secretary of the Company.

EXPERIENCE RATING — At the end of each Policy year the Company shall determine the experience rating applicable to the Creditor under the Insurance Company's Experience Rating Plan and any amount returnable shall be paid in a single sum to the Creditor.

Creditor agrees to insure all loans it has under this policy, who are not 65 years of age.

Application

Application is hereby made to Industrial Life Insurance Company, Columbia, South Carolina, for a Master Group Credit Life Insurance Policy covering all the Lives of the Debtors of Consumer Investment Company, Inc. whose principal place of business is Camden, S. C. (Who are not 65 years of age.)

It is estimated that at least 100 Debtors would be eligible for such insurance during the next 12 months.

Mar. 1-1962 (Date)	Consumer Investment Co. Inc. (Full Corporation Name of Applicant)
Mary Jean Todd (Witness)	BY: A. Gilford Trapp, Exec. V-Pres. (Signature and Title)

SUMMONS

TO THE DEFENDANTS ABOVE NAMED:

YOU ARE HEREBY SUMMONED and required to answer the Complaint in the above captioned action of which a copy is herewith served upon you, and to serve a copy of your Answer to the said Complaint on the subscribers at their offices at 1518 Washington Street, Columbia, South Carolina, within sixty (60) days after the service hereof, exclusive of the day of such service; and if you fail to answer the Complaint within the time aforesaid, the plaintiff in this action will apply to the Court for the relief demanded.

BERRY, LIGHTSEY, GIBBES
and BOWERS,

By: HARRY M. LIGHTSEY, JR.,
Attorneys for Plaintiff.

Columbia, South Carolina,
July, 1970.

COMPLAINT

The plaintiff, complaining of the defendant herein, alleges:

1. That this action is brought in the jurisdiction of this Court pursuant to the provisions of Title 28, Section 1346 of the United States Code for the recovery of Income Taxes wrongfully, erroneously, illegally and excessively collected from the plaintiff for the years of 1963, 1964 and 1965.

2. That the plaintiff did pay to the defendant at its Columbia, South Carolina office, under protest, on or about May 20, 1969, the sum of Forty One Thousand Thirty Seven and 35/100 ($41,037.35) Dollars, being the amount assessed by the defendant, its agents, servants and employees, as being the additional Income Tax, interest and penalty due and owing by the plaintiff for the years 1963, 1964 and 1965 as follows:

1963 Tax	**$13,206.87**	**1964 Tax**	**$15,119.87**	**1965 Tax**	**$4,063.47**
Interest	**4,103.20**		**3,768.59**		**775.35**
Receipt No. F 36531			**$18,888.46**		**$4,838.82**
Total	**$17,310.07**		**F 36530**		**F 36529**

3. That subsequent to the payment of the said sum, the plaintiff filed a claim for refund in accordance with Section 26, Section 7622 of the United States Code, such claim for refund being filed on or about the 30th day of June, 1969.

4. That timely application for refund for the amount paid under protest was made and rejected by the defendant on or about the 8th day of July, 1970.

5. That the plaintiff is entitled to judgment against the defendant in the sum of Forty One Thousand Thirty Seven and 35/100 ($41,037.35) Dollars, being the amount paid under protest of Income Taxes wrongfully, erroneously, illegally and excessively assessed and collected by the defendant, together with interest at the legal rate from the date of payment.

Wherefore, the plaintiff demands judgment against the defendant in the sum of Forty One Thousand Thirty Seven and 35/100 ($41,037.35) Dollars, together with interest from May 20, 1969, and the cost of this action.

BERRY, LIGHTSEY, GIBBES
and BOWERS,

By: HARRY M. LIGHTSEY, JR.,
Attorneys for Plaintiff.

Columbia, S. C.,
July 11, 1970.

VERIFICATION

PERSONALLY appeared before me, Clayton Scyphers, who, being duly sworn, says: That he has read over the foregoing Complaint and that the allegations therein contained are true of his own knowledge, except those matters therein stated to upon information and belief, and as to those he believes them to be true; that the reason this Affidavit is made by deponent is that the Industrial Life Insurance Co. is a Corporation and that he is its President, and he makes this Affidavit for and on behalf of said Corporation.

CLAYTON SCYPHERS

SWORN to before me this
12th day of July, 1970.
EUNICE G. HULMAN,

Notary Public for South Carolina.

My Commission Expires 2-24-74.

ANSWER

The defendant, United States of America, for its answer to plaintiff's complaint herein, admits, denies and alleges as follows:

1. Admits the allegations contained in plaintiff's paragraph 1, except denies that the collection was wrongful, erroneous, illegal or excessive.

2. Admits the allegations contained in plaintiff's paragraph 2, except denies that any of the amount assessed was a penalty.

3. Avers that defendant is presently without information or knowledge sufficient to form a belief as to the truth of the allegations contained in plaintiff's paragraph 3, except admits that plaintiff filed on June 30, 1969, claims for refund, which speak for themselves, for the years 1963 through 1965.

4. Denies the allegations contained in plaintiff's paragraph 4, except admits that plaintiff's claims for refund were denied by the Internal Revenue Service on July 8, 1970.

5. Denies the allegations contained in plaintiff's paragraph 5.

WHEREFORE, defendant prays for judgment in its favor, for its costs, and for such other and further relief as the Court deems just and proper.

JOSEPH O. ROGERS, JR.,
United States Attorney.

By: CHARLES W. GAMBRELL,
Assistant United States
Attorney.

CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that service of the foregoing answer has this 14th day of September, 1970, been made on counsel for plaintiff by depositing a copy thereof, postage prepaid, in the United States mail addressed to Harry M. Lightsey, Jr., Esquire, Berry, Lightsey, Gibbes and Bowers, 1518 Washington Street, Columbia, South Carolina 29201.

CHARLES W. GAMBRELL,

SUPPLEMENTARY ANSWER TO DEFENDANT'S INTERROGATORIES

Plaintiff, being duly sworn and answering Interrogatory No. 74 of the defendant, states:

Plaintiff sets forth below, in answer to Interrogatory No. 74, the premium income realized by the Company in the years 1963, 1964 and 1965. It is plaintiff's contention that all income of plaintiff was, in fact, insurance income since all such income was realized in the general pursuit of the objections of an insurance company business.

(a) Credit life insurance under blanket policy with CIC Corporation, Camden, South Carolina, involving approximately fifteen hundred individuals who are in effect insured, none of whom to plaintiff's knowledge are related to Mr. Clayton Scyphers.

1963	*1964*	*1965*
$2,572.46	$3,517.56	$3,423.92

(b) Individual, weekly premiums, Industrial Life Insurance—All policies on members of family of Mr. Clayton Scyphers.

1963	*1964*	*1965*
$ 83.20	$ 41.60	None

(c) Ordinary Life insurance—Paid by Industrial Life Insurance Company as premiums on key life policies on officers of the Corporation, Mr. Clayton Scyphers is the principal officer of this Corporation.

1963	*1964*	*1965*
$3,561.25	$3,236.95	$6,992.00

TOTAL PREMIUM INCOME:

1963	*1964*	*1965*
$6,216.91	**$6,796.11**	**$10,423.92**

(Per Insurance
Commission Report.
Company records show
$8.00 less.)

Clayton Scyphers, being first sworn, states that he is President and Treasurer of Industrial Life Insurance Co.; that he is authorized to make the foregoing Answer, and that they are true to the best of his knowledge, information and belief.

Clayton Scyphers

SWORN to before me this
19th day of November, 1971.
Eunice G. Hulman,

Notary Public for South Carolina.

My Commission Expires: 10-27-74.

Harry M. Lightsey, Jr.,
Attorney for Plaintiff.

CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that service of the foregoing Supplementary Answer to Defendant's Interrogatories has this 19th day of November, 1971, been made on counsel for defendant by depositing a copy thereof, postage prepaid, in the United States mail.

Harry M. Lightsey Jr.

IN RE: INDUSTRIAL LIFE INSURANCE CO.

Gaston, S. C.

SALES OF LOTS

Grantor	*Grantee*	*Book & Page*	*Date*
Wholesale Life Ins. Co.	Frank A. Long	FD-456	6-21-56
Wholesale Life Ins. Co.	Lester R. Lucas	FD-289	5- 1-56
Wholesale Life Ins. Co.	Arnold R. DeBruhl	FD-193	1-24-56
Industrial Life Ins. Co.	One Hundred Forty-Nine E. Bay	FJ-313	12- 7-56
Industrial Life Ins. Co.	One Hundred Forty-Nine E. Bay	FJ-478	12- 7-56
Industrial Life Ins. Co.	Robert T. Mickle, Jr.	FJ-384	12-31-56
Industrial Life Ins. Co.	Charles N. Whitehouse	FJ-383	12-31-56
Industrial Life Ins. Co.	Willie F. Baker	FJ-382	12-31-56
Industrial Life Ins. Co.	John T. Linder	FJ-381	12-31-56
Industrial Life Ins. Co.	A. B. & Lelia Branham	FJ-380	12-31-56
Industrial Life Ins. Co.	Julian W. Suaso	FJ-379	12-31-56
Industrial Life Ins. Co.	William R. Ellis, Sr.	FJ-378	12-31-56
Industrial Life Ins. Co.	Lester R. Lucas	FO-38	12- 5-56
Industrial Life Ins. Co.	Fred H. & Juanita Ross	FS-76	10-31-57
Industrial Life Ins. Co.	Harry L. & Lucille Crosland	FS-99	11- 7-57
Industrial Life Ins. Co.	Ernest R. & Betty Anderson	FS-279	1- 7-58
Industrial Life Ins. Co.	Charles C. Henderson, Sr.	FS-462	3- 8-58
Industrial Life Ins. Co.	Jesse F. & Joanne Jordan	FS-507	3-19-58
Industrial Life Ins. Co.	J. W. Barfield	FX-288	2-27-59
Industrial Life Ins. Co.	Claude B. Boykin	FX-532	5-14-59
Industrial Life Ins. Co.	Heyward Branham	GB-212	8-25-59
Industrial Life Ins. Co.	Scott L. Elliott	GB-211	8-25-59
Industrial Life Ins. Co.	Lester E. Magaw	FX-431	4- 5-59
Industrial Life Ins. Co.	Louis & Lena C. Belk	GB-128	7-14-59
Industrial Life Ins. Co.	Heyward F. & Pasty Kirby	GB-206	8-26-59
Industrial Life Ins. Co.	Jack R. Kelly	GB-205	8-25-59
Industrial Life Ins. Co.	Burrell E. Price	GE-376	6-23-60
Industrial Life Ins. Co.	Edward W. Mathis	GE-327	5-26-60
Industrial Life Ins. Co.	Clyde L. Morrow	GE-321	5-24-60
Industrial Life Ins. Co.	Jimmy McCaskill	GE-308	5- 4-60
Industrial Life Ins. Co.	John H. Creel	GO-426	11- 8-61
Industrial Life Ins. Co.	Lucas V. Wooten	GO-487	12- 2-61
Industrial Life Ins. Co.	William C. Mangum	GO-479	11-18-61
Industrial Life Ins. Co.	William B. Collins	GO-488	12- 2-61
Industrial Life Ins. Co.	Arnold E. Buzzell	GO-217	7-31-61
Industrial Life Ins. Co.	James Williams	GO-170	7-14-61
Industrial Life Ins. Co.	John D. Knight	GO-171	7-14-61
Industrial Life Ins. Co.	Dean E. Jackson	GO-169	7-14-61

Grantor	*Grantee*	*Book & Page*	*Date*	
Industrial Life Ins. Co.	Hubert H. Brown	GT-163	8-31-62	
Industrial Life Ins. Co.	Cager & Julia Mickle	GP-158	2- 1-62	
Industrial Life Ins. Co.	Thomas Nickols	GP-499	5-29-62	
Industrial Life Ins. Co.	Clayton Scyphers	GX-477	7-18-63	1 lot
Industrial Life Ins. Co.	Clayton Scyphers	HD-122	9-14-63	9 lots
Industrial Life Ins. Co.	Clayton Scyphers	HL-250	8-29-64	11 lots
Industrial Life Ins. Co.	Clayton Scyphers	HR-438	9-14-63	
Industrial Life Ins. Co.	Tetterton & Riddick, Inc.	HY-156	8-28-70	
Industrial Life Ins. Co.	Business Brokers of the South	HR-489	1-10-66	150,000
Industrial Life Ins. Co.	Clayton Scyphers	HR-459	1- 3-66	
Industrial Life Ins. Co.	Martin & Assocs., Inc.	HY-1193	3-20-71	16 lots
Industrial Life Ins. Co.	Grover D. & Claudine Parr	HY-1115	3-10-71	

Importance tax-pay's note:

This part of this Federal regulation 1.801-3 (a) (1) is based on *Bowers v. Lawyers Mortgage Company*, 285 U. S. 182 (1932) which was and is the law of our case today and we quote

> "It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code".

This part of this Federal Regulation did not attempt to change the 50% life reserve definition of sec. 801. Therefore, real-estate sales beyond the tax years of 1963, 1964 and 1965 could not be admissable.

IN RE: INDUSTRIAL LIFE INSURANCE CO.

Gaston, S. C.

RECORD OF PLATS

Name of Plat	*Book & Page*	*Date*
Mayfield Subdivision	24-107	11-30-55
Mayfield Subdivision	24-136	11-14-55
Mayfield Subdivision	34-2128	3- 8-71
Mayfield Subdivision	18-38	5-22-58
Mayfield Subdivision	20-140	6- 1-57
Mayfield Subdivision	20-142	5-31-57
Mayfield Subdivision	22-15	8-13-56
Mayfield Subdivision	34-185	?
Mayfield Subdivision	34-218	?
Mayfield Subdivision	34-219	3- 2-66

STATE OF SOUTH CAROLINA

DEPARTMENT OF INSURANCE

Columbia, South Carolina
June 28, 1971

CERTIFICATE

During the years 1963, 1964 and 1965, the Reserves were required by law in South Carolina on Life Insurance. This Reserve was calculated basically on a mortality base.

The examiners of this Department have examined the records for the Industrial Life Insurance Company for 1963 and 1966. For the year 1963, the examiner's Reserve calculations agreed with those of the Company; and in 1966, the examiners increased the Company's Reported Reserve by $30.00.

This Department has accepted the Reserve figures as reported by the Company for the years 1964 and 1965.

The Reserves reported by the Company and examined and/or accepted by this Department were Reserves on Life Policies and Contracts only.

JOHN L. REYNOLDS,
Deputy Commissioner,
Administration.

JLR:jcm

The State of South Carolina, CHARTER

EXECUTIVE DEPARTMENT BY THE SECRETARY OF STATE

WHEREAS,

John E. Edens, Ma y na Fellers, and

Clay Rice, all of Columbia, S.C.,

did on the **19th.** day of **April**, 19**39**, file with the Secretary of State a written Declaration, signed by themselves, setting forth:

FIRST: That their names and residences are as above given.

SECOND: That the name of the proposed corporation is **GENERAL INSURANCE CORPORATION**

THIRD: That the principal place of business is **COLUMBIA, S.C.**

FOURTH: That the general nature of the business which it is proposed to do is **to issue contracts of insurance against all manner of hazards, including sickness, accident, death, casualty and liability, and all other forms of insurance contracts; to buy, sell, mortgage, and lease real estate, and to do all things necessary and incident to the above powers.**

STATE OF SOUTH CAROLINA
EXECUTIVE DEPARTMENT
Pursuant to law the Capital Stock of the
within Corporation has this day been increased
to the sum of $10,000.00
Ten thousand Dollars,
divided into One hundred [illegible]
of the par value of $100.00 Dollars each
[illegible] thousand (2,000) Dollars each
[illegible] without par value
[illegible] Hand and the Seal of the
3[illegible] day of October
Blackwell
Secretary of State

and Two thousand (2,000) shares of Class B Stock without par value

FIFTH: That the [illegible] Ten Thousand ($10,000.00)------------------ Dollars.

insurance against [illegible], including sickness, accident, death, casualty and liability, and all other forms of insurance contracts; to buy, sell, mortgage, and lease real estate, and to do all things necessary and incident to the above powers.

STATE OF SOUTH CAROLINA
EXECUTIVE DEPARTMENT
Pursuant to law the Capital Stock of the
within Corporation has this day been increased
to the sum of $10,000 Dollars
Ten thousand and 00/100
divided into One hundred (100)
shares of the par value of $100 Dollars each
and twenty thousand (20,000)
shares of Common Stock without par value
and Two thousand (2,000) shares of Class B Stock without par value
Given under my hand and the Seal of the
State at Columbia, this [illegible] day of October
A.D. 19[illegible]
W. P. Blackwell
Secretary of State

FIFTH: That the [illegible] Ten Thousand ($10,000.00)-------------- Dollars.

payable in cash.

SIXTH: That the number of shares into which the capital stock [illegible] one thousand (1,000)

at the par value of Ten ($10.00)-------------------------- Dollars.

SEVENTH: That, after due notice [illegible] 8th. day of April 39 [illegible] at which a majority [illegible] person or by proxy, the following were elected directors: Clay Rice, John E. Edens and Paul A. Schneider.

EIGHTH: That subsequently there [illegible] Dan W. Davis [illegible]; Mary Lina Pellers [illegible] as Vice President; Clay Rice; as Treasurer, As General Counsel, John E. Edens.

NINTH: That all [illegible] and all amendments thereto have been duly and [illegible] stock having been subscribed by bona fide subscribers [illegible] public notice of the intention to file [illegible] The State [illegible] Richland.

NOW, THEREFORE, [illegible] as the applicants are vested by the above said Code [illegible] organized according to the laws of South Carolina, under the name and for the purposes [illegible] that they are fully authorized to commence business under their charter [illegible] filed and recorded in the office of the Register of Mesne Conveyances [illegible] office.

[illegible] Columbia, [illegible] 10th. [illegible] April [illegible]

[illegible] thirty-nine [illegible]

[illegible] sixty-third [illegible]

W. P. BLACKWELL,
Secretary of State.

CERTIFIED TO BE A TRUE AND CORRECT COPY AS TAKEN FROM AND COMPARED WITH THE RECORDS ON FILE IN THIS OFFICE UNDER DOMESTIC CORPORATION FILE NUMBER 20031

O. FRANK THORNTON, SECRETARY OF STATE

INDUSTRIAL LIFE INSURANCE COMPANY
Gaston, South Carolina
BALANCE SHEET

ADMITTED ASSETS	*1963*	*1964*	*1965*
Stocks	$ 24,500.00	$ 50,994.23	$ 67,000.00
Mortgage Loans on Real Estate	117,637.42	106,868.42	107,514.28
Real Estate	60,210.87	60,210.87	60,210.87
Collateral Loans	10,000.00	....	....
Cash and Bank Deposits	22,775.12	44,709.79	39,967.28
Cash Surrender Value of Life Insurance	6,365.00	9,460.00	15,890.00
Investment Income Due and Accrued	210.00	210.00	210.00
Total Admitted Assets	$241,698.41	$272,453.31	$291,392.43
LIABILITIES			
Reserve for Life Policies	$ 3,308.00	$ 6,248.00	$ 12,304.00
Accrued General Expenses	50.00	50.00	50.00
Accrued Taxes, Licenses and Fees	125.00	125.00	125.00
Accrued Federal Income Taxes	2,750.00	3,300.00	2,200.00
Remittances and Items Not Allocated	....	....	10,000.00
Mandatory Securities Valuation Reserve	212.25	237.75	307.83
Total Liabilities	$ 6,445.25	$ 9,960.75	$ 24,986.83
NET WORTH			
Capital Paid Up	$ 2,500.00	$ 2,500.00	$ 2,500.00
Unassigned Surplus	232,753.16	259,992.56	263,905.60
Total Net Worth	$235,253.16	$262,492.56	$266,405.60
Total Liabilities and Net Worth	$241,698.41	$272,453.31	$291,392.43

I, John L. Reynolds, Administrative Deputy Commissioner, hereby certify that these are the balance sheet figures furnished to the South Carolina Department of Insurance by the Industrial Life Insurance Company, Gaston, South Carolina, for the years indicated.

Given under my hand this the 2nd day of December, 1970.

JOHN L. REYNOLDS,
Administrative Deputy Commissioner,
South Carolina Insurance Department.

INDUSTRIAL LIFE INSURANCE COMPANY

FINANCIAL SUMMARY

Year	*Total Admitted Assets & Unassigned Surplus*	*Reserves for Insurance*	*Premium Income*	*Investment Income*	*Actual Life Exposure*
1963	$241,698.41	$ 3,308.00	$ 6,216.91	Net-$4,942.15	$280,460.00
	232,753.16	(a) 64.00	(a) Industrial Life—83.20		(a) 500.00
		(b) 12,109.00	(b) 6,992.00 Life—3,561.25		(b) 5,000.00
		(c) 113.00	(c) Credit Life—2,572.46		(c) 274,960.00
1964	$272,453.31	$ 6,248.00	$ 6,796.11	Net-$8,424.51	$310,364.00
	259,992.56	(a) 72.00	(a) 41.50		(a) 500.00
		(b) 6,026.00	(b) 3,236.95		(b) 10,000.00
		(c) 150.00	(c) 3,517.56		(c) 299,864.00
1965	$291,392.43	$12,304.00	$10,423.92	Net-$9,998.95	$362,392.00
	263,905.60	(a) 80.00	(a) None		(a) None
		(b) 12,109.00	(b) 6,992.00		(b) 20,000.00
		(c) 115.00	(c) 3,431.92		(c) 342,392.00

This is the xerox extraction from the 57th, 58th and 59th report to the Governor and Legislature by the Insurance Department so far as Industrial Life is concerned, and which Mr. Lightsey agreed to put into the record so the Court would not have to read three large booklets. See Record Transcript page 110 where Mr. Lightsey agrees to give the Court this xerox summary.

Short Summary of the Testimony of Mr. A. Gilford Trapp: Starting on Page 4 of R. Trs.

Mr. A. Gilford Trapp, President of the First State National Bank of S. C., now of 105 Lehigh Avenue, Belvedere, S. C., surburb of Augusta, Georgia, testified he was Industrial Life Insurance Company agent at Camden, S. C. during the tax years of 1963, 1964, and 1965. That as manager, he wrote credit life policies for Industrial Life Insurance Company that his company was in the business of buying chattel mortgages on appliances and that he insured these purchases so if they died Industrial Life would save his company harmless to the extent of Industrial Life's liabilities which stopped at $2,000 per risk, which insurance was written on all his customers and that Industrial Life insured a blanket coverage covering all his customers, and Industrial Life's total exposure was from $275,000 to $350,000 and his unpaid balance would average around $250 per risk and according to our calculations, 1,200 risks at an average of $250 per risk would have been $300,000 total exposure, which is $50,000 less than the highest total exposure and $25,000 greater than the lowest exposure which meant that Industrial Life had at least 1,200 separate risks all over the state insured by this blanket policy during the three tax years of this case. For verification of what Mr. A. Gilford Trapp said, see R. transcript p. 4-10 and more particularly p. 4:

R. transcript p. 4:

> Q. "Mr. Trapp, would you please state your name and address for the Court?"
>
> A. "Gilford Trapp, 105 Lehigh Avenue, Belvedere, South Carolina."

R. transcript p. 5:

Q. "Mr. Trapp, during the years 1963, 1964, and 1965, what work did you do?"

A. "I was manager of a dealer finance company."

Q. "What was the name of that company?"

A. "Consumer Investment Company."

Q. "Sometimes called CIC Corporation?"

A. "Correct, sir."

Q. "In connection with that business, did CIC Corporation have any relationship or enter into any relationship with Industrial Life Insurance Company, the plaintiff in this case?"

R. transcript p. 6:

A. "Yes, sir, we did. We had a blanket life insurance policy through their company."

Q. "What was the purpose of those life insurance companies policies, Mr. Trapp?"

A. "To protect the CIC against loss from the death of a purchaser."

Q. "Was it what is commonly called credit life insurance?"

A. "Credit Life insurance, right."

Q. "At that time, was a policy or a master policy of insurance issued from Industrial Life to CIC Corporation?"

A. "Yes, it was, we call a blanket policy."

Q. "Now, under that blanket policy, what steps were taken as to the borrowers whose paper was financed by CIC Corporation?"

A. "Well, all the borrowers were insured under the blanket policy. There was a restriction as to the maximum limit—I think it was two thousand dollars, if my memory serves correctly—and if the loan was in excess of two thousand, only two thousand was covered under the policy."

Q. "These loans were insured with Industrial Life Insurance Company?"

A. "That's correct."

Q "During this 3-year period? Are you familiar with or can you give the Court a general idea as to the amount of credit life insurance involved during these three years?"

R. transcript p. 7:

A. "To my best memory, I think it ranged from probably two hundred and seventy-five thousand to around three hundred and fifty thousand dollars."

Q. "What is your impression or opinion of the average size loan which was insured under this arrangement with Industrial Life?"

A. "It would generally be in the area of $250; could be as low as $200 or $300. Basically, this was caused from the $2,000 limit."

R. transcript p. 8:

Q. "During this time, even though you were an officer of CIC Corporation, did you act as agent for writing this insurance on these loans?"

A. "I did."

Q. "For Industrial Life Insurance Company?"

A. "Yes."

A. "That was the coverage, dollar volume of coverage, not premium volume."

Q. "That was the face amount?"

A. "Yes."

Q. "Of the exposure of Industrial?"

A. "Right."

Q. "On debtors of Consumer Investment Company. State whether or not this business was written on a reducing term basis?"

R. transcript p. 9:

A. "The—it was written on a—what we call a monthly reporting form of balances outstanding on a monthly basis."

Q. "All right, let's assume that the consumer who had a $250 loan had paid $125 off, and then he died. What would Industrial Life have paid to your employer under that policy?"

A. "125."

Q. "So, it was, in effect, reducing term insurance?"

A. "Yes, sir."

Q. "You are not talking about ordinary life insurance?"

A. "No, sir."

Q. "You are talking about short-term credit life insurance, written in the consumer finance business?"

A. "Right, sir."

Q. "What was the longest term of an installment contract that Consumer Investment Company would insure during the years 1963, 1964, and 1965?"

A. "Three years."

Q. "Three years was the maximum term?"

A. "Yes, sir."

Q. "I believe you said you were an agent for Industrial Life?"

A. "Yes, I was licensed."

Q. "Did you personally receive a commission on this business?"

A. "No, sir."

Q. "Did your employer receive a commission?"

A. "Yes, sir."

A. "It was, because the license was issued. As I recall, they had reserves on the industrial policies and reserves on the so-called credit policies."

Q. "Credit life policies?"

A. "Yes."

Q. "Principally, were their reserves reserves on life insurance policies, do you recall?"

A. "They were all on life insurance policies."

Short Summary of the Testimony of Mr. John A. Mills: Starting on Page 153 of R. Trs.

For verification of what Mr. John A. Mills said, see R. transcript pp. 153-154.
p. 153:

Q. "Would you please state your name and address for the record?"

A. "John H. Mills, Jr., Columbia, South Carolina."

Q. "Where are you employed, Mr. Mills?"

A. "South Carolina Department of Insurance."

Q. "What responsibility do you have there at this time?"

A. "I am Assistant Actuary."

Q. "Were you employed by the Department at any time during the period of 1963 to 1965?"

A. "I was."

Q. "What responsibility did you have then?"

p. 154:

A. "I was an Actuaral Examiner."

Q. "Did you have occasion during any of those years to examine the books and records of Industrial Life Insurance Company?"

A. "I did. I participated in the examination as of December 31, 1963."

Q. "In other words, that would be for the year 1963?"

A. "And the two prior years."

Q. "As a part of that examination, do you determine—do you make a financial report, an accounting report, as to the results of your examination?"

A. "We do, to the Chief Insurance Commissioner."

Q. "In that report, did you find or determine any deficiency in the reserves of Industrial Life Insurance Company?"

A. "We did not."

Q. "So far as you were concerned, those reserves were adequate?"

A. "As far as the State statutes are concerned."

Q. "To the best of your knowledge, at that period of time, did the South Carolina Insurance Commission regard Industrial Life Insurance Company as a regulated life insurance company?"

A. "They did."

Short Summary of the Testimony of Mr. Reynolds: Starting at Page 107 of R. Trs.

For verification of what Mr. John L. Reynolds said, see R. transcript p. 107-115 and more particularly p. 107.

Q. "Mr. Reynolds, would you please state your name and address for the court?"

A. "I am John L. Reynolds; reside in Columbia, South Carolina."

Q. "What is your employment, Mr. Reynolds?"

A. "I'm with the South Carolina Department of Insurance.

Q. "How long have you been working with the Insurance Department in S. C.?"

A. "Since July 1, 1962."

Q. "And I take it from your answer, of course, you would have been working with the Department during the years 1963, 1964, and 1965?"

A. "Yes, sir."

Q. "What position do you presently hold and what are the responsibilities of that position with the Insurance Department?"

A. "I'm Deputy Commissioner in Charge of Administration. I am—you might say—the financial officer of the Department, having responsibility for the physical plant, or personnel, payroll, budget, this sort of thing."

P. 108

Q. "In the three years I have been referring to, 1963, '64, and '65, Mr. Reynolds, what position?"

A. "The Financial Analyst Section of the Department audits both—well, audits for mathematical accuracy and completeness the annual statements as filed by the various insurance companies operating in the state."

Q. "In what connection, Mr. Reynolds, would you mind taking just a minute and please explain for us what type of examinations or checks or controls the Insurance Department maintains over insurance companies that are licensed to do business in South Carolina?"

A. "Well, there are various controls. You are speaking primarily of financial controls?"

Q. "Yes, sir."

p. 109

Q. "Under these procedures, how often are examinations or audits or this type of check performed on the companies by the Department as a rule?"

A. "This type check or audit is done annually."

A. "Yes, sir, the South Carolina law further requires that each insurance company operating in the state be examined at least once every three years."

Q. "Now, are you aware of the fact that the plaintiff in this case, Industrial Life Insurance Company, is licensed by the S. C. Department of Insurance to do business?"

A. "Yes, sir."

Q. "As an insurance company in S. C.? To the best of your knowledge, was it so licensed in 1963, '64, and '65?"

A. "Yes, sir."

Q. "As a result of the audits and the procedures you have just described, does the Insurance Department publish an official publication known as "The Annual Report of the Insurance Department of South Carolina?"

Q. "And does it contain the various financial figures and statistical results from the company or either the Commission's records appropriate to all of the insurance companies licensed to do business in S. C.?"

p. 110

A. "Yes, sir, the figures as presented to the Commission in these annual statements are printed in this booklet."

Q. "I hand you three documents and ask you would you please identify those for me?"

A. "They are the fifty-seventh, fifty-eighth and fifty-ninth annual report of the Department of Insurance of the State of South Carolina, covering business reported for the years, 1963, '4 and '5."

Mr. LIGHTSEY: "Your Honor, I have—at this time, I will hand up—I have extracted by xerox copies the pages that are applicable to this company. And I will provide the Court with those."

p. 111

Q. "Mr. Reynolds, do these books contain in them the financial and operating statements with regard to Industrial Life Insurance Company?"

A. "Yes, sir."

Q. "Do they also contain a diagram, indicating the amount of insurance of various different types actually in force at the end of that period?"

A. "A table, yes, sir."

p. 112

A. "It's referred to as Part 2, Section B, Business in Force, on Page 36 of the Fifty-seventh Annual Report."

Q. "For example, in that year, how much total insurance business did Industrial Life have in force?"

A. "$280,460."

p. 113

Q. "Mr. Reynolds, what—in what manner did you participate in the examination or audit of the checks with regard to Industrial Life Insurance Company during the three years that we have discussed, '63, '64, '65?"

A. "I did one or two years myself. I don't remember just which ones. I did—the other year or two was done under my supervision. As I stated before, the annual statement is checked for mathematical accuracy, to make sure that those schedules that are required to be complete are completed; that those schedules are mathematically correct. When this has been done, any and all corrections necessary having been made, then the figures in the statement are compared, or as we say, analyzed and their relationship to one another and to previous years is noted."

Q. "What was the result of these examinations by the insurance company, in regards to the reserve of Industrial Life?"

A. "No change was made or suggested to be made, recommended to be made, in the reserves of Industrial Life for those years."

Q. "So, in substance, from that point of view, the Insurance Commission accepted the reserves as filed by Industrial Life Insurance Company?"

A. "The Insurance Commission accepted the reserves as filed."

Q. Could you state whether or not to your knowledge the Insurance Commission took any action with regard to issuing a certificate during these years to Industrial Life Insurance Company?"

A. "What type of certificate?"

p. 114

Q. "Certificate to do business as an insurance company in the State of South Carolina?" In fact, I believe it was a life, accident and health license? Right?"

A. "Right."

p. 115

Q. "What is the present requirement?"

A. "Six hundred thousand in each. (YEAR)

Q. "Do you know whether or not Industrial Life Insurance Company is what is commonly called a Grandfather Clause company should make an effort to maintain the reserve requirements specified by statute under the South Carolina law?"

A. "This is an opinion, and I think that they should, yes, sir."

RE-DIRECT EXAMINATION

p. 129

By Mr. LIGHTSEY:

Q. Mr. Reynolds, I perhaps gave an erroneous impression with the questions I asked or maybe used the wrong word, but what I meant to ask you earlier relevant to what now Mr. Gambrell is cross-examining you on, was with regard to the capital and surplus requirements under the statute—and I think Mr. Gambrell has already pointed out in his cross-examination that under the statute, it may not be necessary for the company—or it may not be required by law that the company require that. What I asked you is, based upon your responsibility which you have as Chief

Analyst with the Insurance Department, what would be your opinion
page 130
as to the desirability of an insurance company, even though it had a Grandfather Clause, trying to meet the minimum capital and surplus standards set forth in the statute?

A. I would take the position that it is most desirable that they increase capital and surplus.

Q. Would you encourage such a company to try to meet that goal?

A. I would have encouraged the company to do so.

Q. As a matter of fact, do you regard that surplus as a maximum or the end of the road for them, or is that pretty much a statutory minimum that has been established?

A. It's considered a minimum.

Excerpt from Testimony of Arthur Crooks Eddy: Taken from Pp. 261-262 Transcript.
P. 261

* * *

Q. As an actuary, advising insurance companies, state whether or not you would feel that it was advisable that the company, whether or not it had—well, of course, it would have to—even if it had a Grandfather Clause—let me put it that way—attempt to earn or retain funds sufficient to meet the capital and surplus requirements as expressed in the statute?

A. It would be a matter of good business judgment to maintain an adequate amount of protection over and above your measurable liabilities. The life insurance business, in particular, is one based on averages and probabilities, and there's an imponderable involved, even though you have established statutory liabilities. You may by chance fluctuation have a claim or series of claims that would exhaust your reserve; and, therefore, you do to some extent have need for some extra funds to protect against that possibility.
P. 262

Q. In like manner, would you feel, on the basis of your experience as an actuary, that such a company should attempt to reserve funds sufficient to comply with the capital

and surplus requirements expressed in these State statutes, even though it might have a Grandfather Clause?

A. Yes. I don't think that the statute itself is any more important than the business considerations, if you are trying to be practical. I think all companies should endeavor—as a matter of fact, it's my opinion that the statutes are in the right direction in minimizing the unsound possibilities of companies entering the life insurance business without adequate capital.

* * *

Short Summary of the Testimony of Mr. William Sutton: Starting at page 236 of Record Transcript.

For verification of what Mr. William W. Sutton said see R. Transcript P. 236-244.

P. 236:

Q. "Mr. Sutton, would you please state your name and address for the Court?"

A. "William W. Sutton, Apartment 2-1, Senate Plaza Apartments."

Q. "What is your occupation, Mr. Sutton?"

A. "Certified Public Accountant."

Q. "With what office do you work in Columbia, South Carolina?"

A. "Clarkson, Harden and Gantt."

p. 237:

Q. "You were there then, of course, during the years 1963, '64, and '65?"

A. "Yes, sir."

Q. "Did your office prepare the annual statements for Industrial Life Insurance Company? Did you prepare and your office prepare the income tax returns for Industrial Life Insurance Company during those years?

A. "Yes sir."

Q. "I hand you three documents, marked "Plaintiff's Exhibits 7, 8, and 9, and ask you would you examine those and see if those are the income tax returns that were filed on behalf of or by Industrial Life Insurance Company?"

A. "Yes, sir."

Q. "What type of—what form number is that technically known as?"

A. "It's 1120-L. It's a tax return or form for a life insurance company."

Q. "Do you know whether the Government mails those out, the Internal Revenue Service, to taxpayers?"

A. "Yes, sir."

Q. "Were those mailed by the Government to Industrial Life Insurance Company?"

A. "Yes, sir."

p. 239:

Q. "Mr. Sutton, just briefly, to assist the Court—we won't go through all these figures but in each of those columns, there appear three letters, "A, B, and C. Would you please explain what "A, B, and C, represent?"

A. "Third column from the left?" This is the—these are the reserves as reported in this report by the Insurance Commission, "A" being the reserves on the industrial life; "B" on the ordinary life; and "C" on the credit life."

p. 240:

Q. "And throughout that document, isn't that correct, regardless of which column it is under, "A" represents the . . ."

A. "Right, it refers to the—well, "A" refers to industrial life; "B" to the ordinary life; and "C" to the credit life."

Q. "Mr. Sutton, there was a question raised yesterday concerning the valuation of certain property or real estate owned by the company. Would you mind looking in the—for example, Defendant's Exhibit A, at Page 20—I beg your pardon—Page 19. Are you familiar with the valuation of property there?"

A. "Yes, sir."

Q. "It was noted yesterday that that figure is some considerably in excess of the actual acquisition cost of this property by the company. Would you please explain why that happens to be so?"

A. "Yes, sir, in 1958, when life insurance companies became taxable, they allowed the old life companies to value their real estate at market value as of the date."

Q. "And, in other words, this is the result of the higher valuation under the 1958 statute?"

A. "Yes, sir."

Q. "Under that 1958 statute, what was the result as to the basis for that property for tax purposes?"

A. "It was—the basis was increased. As to how much, I can't testify."

p 241:

The COURT: You mean when life insurance companies became taxable under IRS, they allowed them to write up the basis of their real estate?"

A. "For tax purposes, yes, sir."

The COURT: "So that if they sold it, the gain would be on the new basis rather than the acquisition basis?"

Mr. LIGHTSEY: In face, that's what, your Honor, creates the major difference of the tax in this case, is that written-up basis, as I understand it."

The COURT: "All right. Go ahead."

Q. "Mr. Sutton, so far as you are familiar with the figures on the income tax returns, were they taken from the annual statements prepared by your office?"

A. "Yes, sir, they were."

Q. "Was your office furnished these figures from the books and records of the company?"

A. "Yes, sir."

Mr. LIGHTSEY: "I think that's all the questions I have. Answer any questions these gentlemen have."

p. 242:

Q. "So for a true balance sheet, if you were preparing a balance sheet for someone else other than the Insurance Department, then these non-admitted assets would have increased the unassigned surplus? Isn't that true?"

A. "That's correct."

p. 244:

A. "The C is the—my calculation—you—on that line, you put the smaller of either 'B', 'A' being the investment income and 'B' being the gain from operations."

Q. "In other words, you then enter in that figure the smaller of 'A' and 'B'? And then so that we won't misrepresent this fact to the Court, then on Number 2, you take 50 per cent of the excess?

A. "That's correct."

Q. "Between "A" and "B''? Isn't that correct? So that not the total investment income and the total gain from operations is taxed in a life insurance situation?"

A. "That's correct."

Q. "Mr. Sutton, I believe you said that you or your firm prepared the annual statements that have been identified and introduced in evidence as Defendant's Exhibits A, B, and C?"

A. "Yes sir."

p. 247

Q. "If he had, would that have been reflected in the balance sheet?"

A. "If there was other liabilities of the company, yes, they would have been reflected in here."

The Witness: "No, sir, contingent liabilities normally are not reflected as a dollar amount. In normal—Yes, sir, in a footnote, you would note it."

p. 248

Q. "Mr. Sutton, is it customary for insurance companies to footnote their annual statements, as filed with the Insurance Department?"

A. "You mean—when you say, "footnote", you mean as to the contingent liability?" "No, sir, it is not usual."

Short Summary of the Testimony of Clayton Scyphers: Starting on page 33 of the Record Transcript.

Q. "Now in the taxable years in question, 1963, 1964, and 1965, did Industrial Life Insurance Company sell certain lots of land out of this real estate that you have just described?

A. Yes, I don't have the exact record. I think we made two or three sales. I had tried to sell this property before '63, '4 and '5, and the present Governor and a man by the name of 'Red' Stogner wanted to buy it. There was some negotiations through Mr. Stogner, the real estate man, and we agreed to sell the 500 acres for $50,000. I have got—at the request of the Government, I can tell you what those three pieces cost, if I could go back to get my notes. I went to the Courthouse and looked."

* * *

Page 34 of Record Transcript:

Q. "In 1963, 1964, and 1965, the three tax years in question, did the Industrial Life Insurance Company convey out certain lots or parcels of land from this tract?

A. Yes, Mr. Lightsey, I went down and talked with the Insurance Commissioner. I had failed to sell this land as a tract to Mr. Stogner and to Mr. West. I had also failed, Mr. Lightsey, to sell it to Ruscon Construction Company—looked like we were, as a whole, but that fell through; and I got permission from the Insurance Commissioner to buy some of these lots myself personally, and he said to me, 'Mr. Scyphers, just how will you pay for them?' And I said, 'I will pay whatever VA and FHA appraises them at. It's not fair to me, but I'll do that.' "

* * *

Page 36 of the Record Transcript:

The WITNESS: "Mr. Lightsey, the conversation wasn't had with Mr. Gambrell. It was by a former Commissioner. And after I failed to sell this property in block—

The COURT: Who was Commissioner at that time?

The WITNESS: I believe Mr. Kelly.

The COURT: This is in the year 1963?

The WITNESS: No, no, prior to that.

Mr. LIGHTSEY: Your Honor, Mr. Scyphers was explaining the background before those years. (Addressing the witness) Let me ask you, Mr. Scyphers, getting back to the point: I believe my question was addressed to these three tax years, 1963, 1964, and 1965.

A. Yes, Mr. Lightsey, I bought some of the lots myself.

Q. That's what I wanted to ask you.

A. I believe in three different deeds.

Q. Would you please describe for the Court to whom the conveyances were made and the amount of consideration that was paid.

A. I paid whatever, Mr. Lightsey, the VA or FHA was allowing for the lot after the house was finished. I paid the insurance company, deposited the money to them, and I built the houses personally, Mr. Lightsey.

Q. In other words, you built the houses personally during these taxable years?

A. Yes, sir, I did, Mr. Lightsey.

Q. And the insurance company conveyed the lots to you?

A. Yes, sir.

Q. Now, did you personally convey these lots with houses on them out to third persons or ultimate purchasers?

A. Yes, sir, I did.

Q. Would you state whether or not the Internal Revenue Service has ever made any determination insofar as you individually are concerned as to whether you were in the ordinary business of conducting a real estate business?

A. Mr. Lightsey, in '65, one of these same years that the Government is now complaining about, I got a note or letter or something—I believe when I got home, I found somebody had been there and some Internal Revenue man had been there and wanted to examine me personally; and so, Mr. Lightsey, he did and his contention was that Clayton Scyphers personally was in the real estate business and that by reason of being in the real estate business, that Clarkson, Harden & Gantt had made a mistake in filing my personal income taxes, that I wasn't entitled to a long-term gain.

After some consideration, Mr Lightsey, I had had the property longer than six months, but I finally paid, Mr. Lightsey—may I say, over the objection of Governor West—I paid $3512.07 on September 14, 1965, which was above my regular taxes. I had already paid my regular taxes, but this was an assessment claimed by the fact that I wasn't—I was in the real estate business. They never mentioned once that the insurance company was in it, because I had bought these three different pieces of property—I don't know—ten, eleven lots at one time.

Testimony of Clayton Scyphers (under Direct Examination): Record Transcript Page 41.

* * *

Q. "Would you please tell the Court what your concerns were, as President of this company during these taxable years, insofar as the capital and surplus requirements of South Carolina law were?

A. Mr. Lightsey, in 1939, when this charter was granted

Record Transcript Page 42

and every time, as far as I know, that the Legislature has upped the capital and surplus, they have allowed the insurance companies to go along—those that were then doing business, then paying their claims, then keeping up their reserves, and no complaint from the Department, allowed them to operate continuously as they had been, under the Grandfather Clause. Each time that the change has been made, the companies has been allowed to operate under the Grandfather Clause. Mr. Lightsey, along about '40, there were many companies—and I don't know the exact number—that was operating under an old charter like this one, under the Grandfather Clause. Now, as they have continued, the last time I looked, I believe they told me there were three companies—and ours was one—still operating under this old, old charter, under the Grandfather Clause. Now, at that time, Mr. Lightsey, they had a requirement—I believe the last time I made a study of it—was four hundred thousand dollars capital and surplus. At

that time, Mr. Lightsey, it may have been for just a very few months that I could have qualified, had the Legislature changed their mind all at once and done away with the Grandfather Clause, but recently, in '71, the Legislature has amended the capital and surplus to six hundred thousand—that's above now your reserve—and I have been very much afraid—I have been trying to draw very low salaries, very low operation expense, trying to keep in shape, so if the Legislature did

Record Transcript Page 43

clamp down on us, and say, "you boys have had long enough now, since 1939 and '69, would have been thirty years—you have had thirty years to get your house in order." They so far haven't done it, but I have been afraid and kept the surplus and capital and operating expenses as low as possible, to try to meet those new requirements as, if and when they were put on us."

Testimony of Clayton Scyphers (Under Direct Examination) Continued: Record Transcript Page 47.

* * *

Q. "Mr. Scyphers, we have had some discussion concerning the risk involved in the reinsurance policies. Would you state whether the Industrial Life Insurance Company has been involved in any way in any claims in connection with such policies?

A. Well, when Mr. Van Slyke was here the last time, I

Record Transcript Page 48

gave him an illustration of one I just had paid. Now, this was the Coastal States reinsurance agreement, and they were on the—they were carrying the risk, and I got a letter from the hospital—Industrial Life did—and they claimed that they had a lady out there in the hospital, and the claim wasn't paid. I didn't pay much attention to the first letter. A month later, I got another letter, insisting that the claim wasn't paid and should be paid. Well, I went out to see this lady. I believe her name was Rosa—do you have that deposition I had back there—Kennedy—Rosa Kennedy—

Q. That doesn't matter.

A. Anyway, I went out there, and she was mad as she could be and claimed that the Coastal States wouldn't pay her, because—they wouldn't pay her because she didn't have a doctor to admit her to the hospital, but she had been to the hospital, as, I believe, from the seventeenth to the twenty-fifth. What actually happened, Mr. Lightsey, rather than having the insurance—

Record Transcript Page 49

Mr. LIGHTSEY: All I'm trying to ask, your Honor—let me put it this way: Has Industrial Life Insurance Company ever paid any claims?

A. Yes.

Q. Insofar as this business that was reinsured is concerned?

Record Transcript Page 50

A. Yes, sir.

The COURT: How many?

The WITNESS: Probably two or three—not many. They have taken care of their claims pretty well but not all the time."

Testimony of Clayton Scyphers (under Cross Examination): Record Transcript Page 86.

* * *

"The COURT: What was the purpose of the agreement, then, if it wasn't to get rid of the primary responsibility?

The WITNESS: Your Honor please, I think it might be well to compare it to a building contractor of this Courthouse, and Mr. Lightsey is a general contractor or Ruscon Construction, and he agrees to build this Courthouse for the Federal Government. He turns around, and Mr. Charlie Gambrell, another contractor comes up and says, "Look here, Harry, I will do this contract for you."

The COURT: You are comparing it to a sub-contractor?

The WITNESS: He is a subcontractor; couldn't be anything else, in my judgment."

STATE OF SOUTH CAROLINA.

AGREEMENT made and entered into this 6th day of September, A.D. 1946, by and between Dixie Life Insurance Company, a corporation created and existing under the laws of the State of South Carolina, with its principal place of business in the City of Sumter, S. C., party of the first part, and Security Life Insurance Company, a corporation created and existing under the laws of the State of South Carolina, with its principal place of business in the City of Columbia, S. C., party of the second part, and Clayton Scyphers, of Columbia, S. C., party of the third part, WITNESSETH:

That it is hereby agreed and contracted by and between the parties hereto, each in consideration of the agreements and undertakings of the others, as follows:

1. That said party of the second part will sell, transfer and deliver to said party of the first part its insurance business of all kinds, which may be in full force and effect on the 3rd day of January, 1947 (except such part thereof as is hereinafter specifically reserved to said party of the second part), the said business to consist, generally, of the following:

> (a) All policy registers and records, collection books and cards, and any and all other books, documents, papers and records evidencing the issuance and delivery of all valid policies then outstanding, and showing the kind and nature of all such outstanding policies and the amounts of the premiums paid or accrued thereon, and which may thereafter become due and payable thereon;
>
> (b) The full amount of the legal reserve required to be held and owned by said party of the second part or to be deposited by it with the Insurance Commissioner of the State of South Carolina, said legal reserve to consist of U. S. Government bonds, fully insured certificates of deposit in building and loan associations doing business in South Carolina, and/or cash, the amount of such legal reserve to be ascertained and determined by on actuary as hereinafter provided, and the amount and nature of such legal reserve to be

approved by the Insurance Commissioner of the State of South Carolina;

(c) All such supplies on hand as may be needed by said party of the first part in continuing the conduct of said insurance business, consisting of blank forms of said policy registers, collection books, cards, receipts, applications, policies, etc.;

(d) All unexpired agreements, contracts and leases for advertising, personal services, telephone, light and water service, and office space; **provided** that if said party of the first part shall decide prior to December 15, 1946, that it does not desire to continue any or all of such agreements, contracts or leases, it shall have the right so to do, and said party of the second part will be notified prior to December 15, 1946, which of said agreements, contracts or leases the said party of the first part does not desire to assume after January 3, 1947, and in such event said party of the first part will be discharged and released of any and all liability thereunder; and

(e) The personal services and good will of the agency and clerical force employed by said party of the second part, insofar as said party of the second part may be able to control and direct the same; **provided,** that said party of the first part shall have the right to designate on or prior to December 15, 1946, such members of said agency and clerical force as it does not desire to employ after January 3, 1947.

2. That said party of the second part reserves to itself from the operation of this agreement the following:

(a) The corporate charter of said party of the second part heretofore issued by the Secretary of State of South Carolina;

(b) Not exceeding five (5) outstanding policy contracts heretofore issued by said party of the second part, which are to be selected by it, together with the books, cards and records pertaining to the same;

(c) Such supplies and forms as may be needed by said party of the second part in connection with said above reserved outstanding policy contracts; and

(d) Office equipment and furniture, bank deposits, cash on hand, accounts receivable, and securities, except so much thereof as may be needed to make up the required legal reserve above provided for in Paragraph 1(b).

3. That the required legal reserve provided for in Paragraph 1(b) above is to be ascertained and determined by a competent actuary to be named by said party of the first part, and the decision of such actuary shall be final. The compensation of said actuary is to be paid by said party of the second part.

4. That said party of the second part assures and hereby agrees to pay and discharge any and all claims, demands, causes of action, suits or liability of any kind or nature whatever which have arisen or which may hereafter arise under, on account of, or by reason of any policies heretofore or hereafter issued by said party of the second part, or under or on account of any agreements, contracts or leases entered into by said party of the second part, save and except such policy liabilities as are taken over and assumed by said party of the first part under Paragraph 1(c) above, and such unexpired agreements, contracts and leases as may be accepted and assumed by said party of the first part under Paragraph 1(d) above. In the event that said party of the first part should be made a defendant or be brought into any suit or litigation arising out of any of the matters or things hereinabove set forth in this paragraph (except those specifically assumed by it), then said party of the second part hereby agrees to indemnify and hold harmless said party of the first part of and from any and all costs, expenses, attorneys' fees, or other charges incurred by said party of the first part in defending or protecting itself from any such suits or litigation.

5. That said party of the first part will on January 3, 1947, or as soon thereafter as may be practicable, notify all policyholders of all policy contracts which it has assumed and taken over under the provisions of Paragraph 1(c) above, and will issue such endorsements or riders as may be necessary to properly evidence such assumption of liability and will deliver said endorsements or riders to

said policy holders to be affixed to their said policies, and thereafter said party of the first part will be solely liable under such policy contracts. In the event that said party of the second part should be made a defendant or be brought into any suit or litigation arising under or out of any policy contract so assumed by said party of the first part, then said party of the first part hereby agrees to indemnify and hold harmless said party of the second part of and from any and all costs, expenses, attorneys' fees, or other charges incurred by it; **provided,** however, that said party of the first part shall have the right to undertake the entire defense of any such suit or litigation.

6. That said party of the second part will allow a representative of said party of the first part to become associated with it in the conduct and operation of its insurance business during the ten weeks period from October 7, 1946 to December 14, 1946, both inclusive, which said ten weeks period shall be known as the "test period". During said "test period" this representative of said party of the first part shall be designated as "Superintendent of Agents", and he shall be permitted to work with, and, together with said party of the third part, shall have supervision over the agency force employed by said party of the second part so as to enable him to become fully acquainted with and to familiarize himself with such agency personnel and with the debits of said party of the second part in Columbia, S. C. and in such other places or territory in which said party of the second part is then operating. Said representative shall receive the full assistance and cooperation of said parties of the second part and third part in the discharge of his duties as "Superintendent of Agents" during said "test period". The compensation and expenses of said representative during said "test period" shall be paid by said party of the first part.

7. That for said insurance business as hereinabove described in Paragraph 1 hereof which is to be transferred to said party of the first part by said party of the second part, the amount to be paid therefor shall be ascertained

and determined as a result of the operations during said above mentioned "test period" on the following basis:

> (a) If the average weekly cash collectible debits on valid outstanding policy contracts actually issued and delivered by said party of the second part shall amount to the sum of Thirty-five Hundred ($3,500.00) per week, then said party of the first part will pay to said party of the second part the sum of Two Hundred Seventy-eight and 83/100 ($278.83) Dollars each week for five hundred and twenty (520) successive weeks, commencing January 10, 1947, said payments to be made on each Friday thereafter during said entire term of five hundred and twenty (520) weeks, without interest thereon.
>
> (b) If the average weekly cash collectible debits determined as aforesaid shall be less than the said sum of Thirty-five Hundred ($3,500.00) Dollars per week, then said weekly payments above stipulated in this paragraph shall be proportionately reduced.
>
> (c) If said average weekly cash collectible debits shall exceed the said sum of Thirty-five Hundred ($3,500.00) Dollars per week, then said weekly payments shall be proportionately increased.

8. That, in determining the average cash collectible debits as above provided in Paragraph 7, there shall be no loading or padding of said debits, nor shall any abnormal advance premium payments be taken into consideration in ascertaining the average weekly cash collections; **provided,** however, that if said party of the first part believes that at the end of said "test period" there have been any abnormal advance premium payments, then said party of the first part shall have the right to take each individual debit collection book or books and actually count the live premiums in force (that is, premiums which are not over four weeks in arrears), and if the aggregate of said live premiums should be less than the average weekly cash collections during said "test period", then said party of the first part shall have the option and right to make the weekly payments

above provided in said Paragraph 7 on the basis of such lesser amount.

9. That, as an inducement and valuable consideration for the purchase of said insurance business by said party of the first part, said party of the second part and said party of the third part hereby covenant and agree that so long as the terms of this contract are fully complied with by said party of the first part, they or either of them shall not directly or indirectly engage in the life, or accident, or health insurance business in the State of South Carolina, nor shall either of them be allowed or permitted to solicit, issue or deliver any policies of life, accident or health insurance of any kind, either on their own behalf or as agent or broker for any other person, firm or corporation, within the State of South Carolina, for the term of two years from January 3, 1947, except with the specific approval and consent in writing of said party of the first part; nor shall said party of the second part or said party of the third part do or perform any act or thing which will in any manner tend to prejudice or reflect upon or adversely affect in any way the business of said party of the first part during the aforesaid two year term, especially with respect to that part thereof which has been purchased and taken over under the provisions of this contract.

10. That said parties of the second and third part further covenant and agree, as an inducement for and consideration of the entering into this contract by said party of the first part, that the charter or charter rights of said party of the second part shall not be assigned, conveyed, sold or transferred in any manner or by any means to any person, firm or corporation whatsoever, at any time during the term of two years from January 3, 1947. At the expiration of said two year term, if said party of the second part or said party of the third part desires to sell the said charter or charter rights of said party of the second part and offers the same for sale, then before any such assignment, conveyance, sale or transfer of the same may

be made, the following conditions must be complied with, to wit:

(a) Said party of the first part shall have the option, right and privilege to purchase the same at such price as may be equal to any bona fide valid offer which may be made therefor, such option to be exercised within not exceeding thirty days after said party of the first part shall have been notified in writing of any such bona fide valid offer of purchase.

(b) If said party of the first part does not exercise the foresaid option within said thirty-day period, then said sale or transfer of said charter or chapter rights may be made to any person, firm, or corporation, but only upon the further express condition and limitation that any such purchaser or transferee shall first take the necessary steps to amend said charter by changing the name of said corporation from "Security Life Insurance Company" to some other name which shall not be similar thereto.

11. That said party of the third part agrees that from and after January 3, 1947, he will work for said party of the first part for a period of not exceeding sixty (60) days, and will serve in such capacity as may be designated by said party of the first part. That said party of the third part will, during said period, devote his full time and best efforts to the advancement and building up of the business of said party of the first part, especially that portion of said business which is purchased and taken over under the provisions of this contract; and for such services said party of the third part will receive and be paid his actual expenses.

12. That after the expiration of five years from January 3, 1947, that is to say, at any time after January 2, 1952, said party of the first part shall have the right and privilege to anticipate payment, in whole or in part, of any sums becoming due hereunder to said party of the second part, said anticipated payment or payments to be discounted at the rate of four (4%) percent per annum for the remainder of the unexpired term.

13. That upon default by said party of the first part in the payment of any weekly installments becoming due hereunder as provided for in Paragraph 7 hereof, or upon the breach by it of any of the other provisions hereof, then and in any such event all rights and interests of said party of the first part under this contract shall thereupon immediately cease and determine, and said party of the second part shall be entitled to take any steps or to institute any action or proceeding that may be proper to obtain redress for any damage or grievance sustained by it; **provided,** however, that no such default shall be deemed or taken to have occurred if within not more than five (5) days after the due date of any weekly payment said party of the first part shall forward its check for such payment by mailing same in an envelope, with postage prepaid, addressed to "Security Life Insurance Company, Columbia, S. C.", or to such other address as said party of the second part may from time to time direct in writing.

14. That upon the breach by said party of the second part and/or said party of the third part of any of the agreements, conditions or provisions of this contract on its or his part to be performed, then and in any such event said party of the first part shall thereupon be absolved, discharged and released of and from making any further weekly payments provided for in Paragraph 7 hereof, and said party of the first part shall also be entitled to take any steps or to institute any action or proceeding that may be proper to obtain redress for any damage or grievance sustained by it.

15. That the sale and transfer of the insurance business of the said party of the second part to said party of the first part as herein provided for shall become effective as of January 3, 1947, and said parties of the second part and third part covenant and agree to execute and deliver any assignments, documents or instruments as may be proper or requisite to fully and effectually complete such sale and transfer of said insurance business to said party of the first part.

16. That it is distinctly understood and agreed between the parties hereto that said party of the first part

does not and shall not become liable or responsible for any debts, obligations, or liabilities of any kind which are now or may hereafter become due and owing by or chargeable against the said party of the second part or the said party of the third part, save and except these liabilities which are specifically secured by said party of the first part under the provisions of this contract, and that the said parties of the second and third part will indemnify and hold harmless the said party of the first part from any such liability and from any and all costs and expenses incurred by it in connection therewith.

17. That this agreement in all of its provisions and terms shall be binding upon and shall inure to the benefit of the signatory parties hereto and their respective heirs, executors, administrators, successors and assigns.

IN WITNESS WHEREOF, Dixie Life Inurance Company, and Security Life Insurance Company have caused their corporate seal to be hereto affirmed, and this instrument to be executed in their respective names by their proper officers, thereunto duly authorized by duly adopted resolutions of their respective Board of Directors, and the same to be executed by Clayton Scyphers (individually), this the day and year first above written.

DIXIE LIFE INSURANCE COMPANY (SEAL)

by ....
President

....
Secretary

SECURITY LIFE INSURANCE COMPANY
(SEAL)

by ....
President

....
Secretary

.... (SEAL)

Signed, Sealed and Delivered in
the presence of:

....

....
(As to Dixie Life Insurance
Company)

....

....
(As to Security Life Insurance
Company)

....

....
(As to Clayton Scyphers)

STATE OF SOUTH CAROLINA,
COUNTY OF SUMTER.

Before me personally appeared ....
.... who, being duly sworn, says that he saw the within named Dixie Life Insurance Company, by S. L. Roddey, its President, and S. G. Brading, its Secretary, sign and affix the corporate seal of said company to the within written instrument, and as the act and deed of said company deliver the same, and that he with ....
witnessed the due execution thereof.

....

SWORN to before me this ....
day of September, A. D. 1946.

............................(SEAL)
Notary Public for S. C.

STATE OF SOUTH CAROLINA,
COUNTY OF RICHLAND.

Before me personally appeared ....

....

.... who, being duly sworn, says that he saw the within named Security Life Insurance Company, by Clayton Seyphers, its President, and A. L. Seyphers, its Secretary, sign and affix the corporate seal of said company to the within written instrument, and so the act and deed of said company deliver the same, and that he with ....
.... witnessed the due execution thereof.

....

SWORN to before me this ....
day of September, A. D. 1946.

............................(SEAL)
Notary Public for S. C.

STATE OF SOUTH CAROLINA,
COUNTY OF RICHLAND.

Before me personally appeared .... who, being duly sworn, says that he saw the within named Clayton Scyphers (individually sign seal, and as his act and deed deliver the within written instrument, and that he with .... witnessed the due execution thereof.

....

SWORN to before me this ....
day of September, A. D. 1946.

............................(SEAL)
Notary Public for S. C.

STATE OF SOUTH CAROLINA,
COUNTY OF RICHLAND.

I, Stanley G. Brading, Secretary of Dixie-Security Life Insurance Company, hereby certify that the foregoing is a true and correct copy of Agreement between Dixie Life Insurance Company and Security Life Insurance Company and Clayton Scyphers.

Stanley G. Brading

SWORN to before me this ....
day of May, A. D., 1947.
Roberta James (SEAL)

....
Notary Public for S. C.

STATE OF SOUTH CAROLINA,
COUNTY OF RICHLAND

AGREEMENT

This memorandum of agreement made and entered into this the 2nd day of February, 1953, by and between Industrial Life Insurance Company, a corporation created and existing under the laws of the State of South Carolina, with its principal place of business in the City of Columbia, South Carolina, hereinafter sometimes referred to as seller, party of the first part, and The First National Insurance Company, a corporation created and existing under the laws of the State of South Carolina, with its principal place of business in the City of Columbia, South Carolina, party of the second part, and Clayton Scyphers and A. L. Scyphers of Gaston, South Carolina, parties of the third part, and Harry A. Turner, V. A. Crout, Alton K. Amick, D. McK. Winter, Jr., and D. McK. Winter, Sr., parties of the fourth part, and J. M. Walker, Sr., Trustee, party of the fifth part.

WITNESSETH:

That it is hereby agreed and contracted by and between the parties hereto, each in consideration of the agreements and under takings of the others, as follows:

1. That party of the first part, Industrial Life Insurance Company, hereby sells, transfers, and delivers unto the party of the second part, The First National Insurance Company, all of its insurance business, good will, all insurance contracts in force, commonly known as its debits, trade name, all policy registers and records, collection books and cards, and any and all other books, documents, papers and records evidencing the issuance and delivery of all valid policies then outstanding, and showing the kind and nature of all such outstanding policies and the amounts of the premiums paid or accrued thereon, and which may thereafter become due and payable thereon.

2. The full amount of the legal reserve required as of the end of the year 1952 to be held and owned by said party of the first part or to be deposited by it with the Insurance Commissioner of the State of South Carolina, said legal reserve to consist of United States Government bonds, fully insured certificates of deposit in building and loan associations doing business in South Carolina, and/or each, or cash in lieu thereof, the amount of such legal reserve to be ascertained and determined by an actuary as hereinafter provided, and the amount and nature of such legal reserve to be approved by the Insurance Commissioner of the State of South Carolina.

3. All such supplies on hand as may be needed by said party of the second part in continuing the conduct of said insurance business, consisting of blank forms of said policy registers, collection books, cards, receipts, applications, policies, etc.

4. All unexpired agreements, contracts and leases for advertising personal services, telephone, light and water service, and office space, and/or insurance contracts; provided, that if said party of the second part shall decide that it does not desire to continue any or all of such agreements, contracts, or leases, it shall have the right so to do, and said party of the first part will be notified prior to February 9, 1953 which of said agreements, contracts or leases the said party of the second part does not desire to assume after March 1, 1953, and in such event said party of the second part will be discharged and released from any and all liability thereunder.

5. The personal services and good will of the agency and clerical force employed by said party of the first part, insofar as said party of the first part may be able to control and direct the same.

6. All office furniture, equipment and supplies not hereinabove designated, including desks, chairs, typewriters, adding machines, and any and all furniture, equipment and supplies kept in or used in connection with the office of Industrial Life Insurance Company.

7. The name, "Industrial Life Insurance Company", with the full right and privilege to amend the charter of The First Nationall Insurance Company so as to make the name of that company, "The Industrial Life Insurance Company", and the present corporation known as Industrial Life Insurance Company will, at the same time, amend its charter so that it will be known by another name.

8. That the required legal reserve provided for in paragraph 2 above is to be ascertained and determined by a competent actuary to be named by said party of the first part, and if his decision is not satisfactory to the party of the second part, and if an agreement not be reached, the findings of the actuary for the Insurance Department of South Carolina shall be final.

9. It is agreed and understood that the party of the first part, designated as seller, and the parties of the third part, will save harmless the party of the second part designated as purchaser, its successors and assigns, from all damage or loss on account of any and all claims and demands of whatsoever nature now or heretofore existing or hereafter growing out of any insurance contract, accounts or obligations of the said Industrial Life Insurance Company, or parties of the third part heretofore done or now existing, whether such claim or claims have been or hereafter may be asserted. It is the intent and purpose of this paragraph to mean that any claim involving H and A or hospitalization shall be the liability of the party of the first part if the period involved for which the claim is submitted ran before the date of this instrument.

10. The party of the first part, and parties of the third part further agree that when and if such claim or claims are asserted that they will immediately satisfy them in full or defend them if suit is brought upon them, and take on all necessary action to save The First National Insurance Company, party of the second part, or its successors and assigns, and parties of the fourth part harmless.

11. The party of the first part and parties of the third part warrant that neither Industrial Life Insurance Company, or parties of the third part, have committed any act or acts or failed to commit any acts, either by commission or omission, which would either tend or cause the State of South Carolina through any of its departments or officials to seek to forfeit the charter or to suspend permanently or temporarily the license of Industrial Life Insurance Company or its successors.

12. The party of the first part, and parties of the third part, designated as sellers, covenant and warrant that all charter fees, license fees, taxes and assessments of every kind and nature have been fully and promptly paid since the incorporation of Industrial Life Insurance Company up to and including the date of execution of these presents, and that Industrial Life Insurance Company is now a duly licensed insurance company in the State of South Carolina and authorized at the present time to engage in the indus-

trial life and accident insurance business in the entire State of South Carolina and which license is more particularly described as follows: Date, April 1st, 1952, bearing No. 546, issued by the Insurance Department of South Carolina, and actually executed by D. D. Murphy, Insurance Commissioner, which license authorized Industrial Life Insurance Company to engage in the sale of industrial life and accident insurance and hospital insurance in South Carolina, state wide, until March 31, 1953, all on an industrial base.

14. From the effective date of this agreement, purchasers shall have the right and option to operate and carry on all of the business and affairs of Industrial Life Insurance Company and to manage and control the same as they may deem proper, said business to be run and managed by Harry A. Turner, as Executive Vice-President and General Manager, that is to say, to sell insurance, adjust claims, collect premiums, hire, discharge and control employees and to generally manage said business of Industrial Life Insurance Company, pertaining to the business and property herein agreed to be sold, provided, this provision shall not apply to any property or business of said company, not herein agreed to be sold, or to the duties of the officers of Industrial Life Insurance Company, with regard to property and business not herein agreed to be sold, and Harry A. Turner will, on February 2nd, 1953, be elected as such Executive Vice-President and General Manager by the present stockholders of the present Industrial Life Insurance Company with all the powers and duties herein provided for to continue or be intermittent at the option of the parties of the fourth part for a period of eight (8) years, or until such time as parties of the fourth part shall buy the charter of Industrial Life Insurance Company or release their option to buy said charter and the transfer of said business to The First National Insurance Company, or its successors, in name or in fact, has been completed, and all benefits of, or increase in or additions to said business during the operation of said Industrial Life Insurance Company, by said Harry A. Turner, as Executive Vice-President shall enure to the benefit of and be the property of The First National Insurance Company, party of the second part, or its succes-

sors in name and in fact, and/or to parties of the fourth part, their executors, administrators or assigns.

It is still further agreed that the party of the first part hereby agrees that the party of the first part hereby agrees to give to the party of the second part, an option to use the present Industrial Life Insurance Company and/or its successors in name and in fact, as a vehicle to operate on, in the manner provided hereinabove, during the next eight (8) years from the date hereof, if such becomes necessary in the opinion of parties of the fourth part or their attorneys.

It is agreed that in case sellers become ready, willing and able to sell and deliver to purchasers the charter and franchise and proper records and papers therewith, exclusive and without any property or property rights of said corporation not herein agreed to be conveyed, then purchasers will either purchase said charter and items as set forth herein and pay therefore the amount and on the terms set forth herein or in lieu thereof, pay to sellers Fifty ($50.00) Dollars per month from the date of such offer until such time as purchasers may elect to purchase said charter and items herein mentioned or may in writing release all options and limitations involved in this agreement and no longer, or until the expiration of eight (8) years from the date of this agreement.

Party of the second part may, at any time during said period determine that it no longer needs the option of using the charter of party of the first part and upon notice of such decision being given to party of the first part, and the said party of the first part shall be released and discharged from its duty to hold said charter for the use of party of the second part and from all charter options and charter limitations and party of the second part shall be relieved from the responsibility of paying any further amounts thereon, provided, that if it becomes necessary in the opinion of the parties of the third part, in order to preserve the present status of party of the first part to re-activate said company under its then new name, such activity as may be necessary may be indulged in, provided the business engaged in shall not be on a weekly premium base, even though this option has not expired.

It is the purpose of this agreement and the parties hereto do hereby agree that as soon as may be reasonably accomplished, after the execution hereof, at the option of attorneys for purchasers, the names of the respective insurance company's will be changed as herein mentioned and the business hereby sold by the present Industrial Life Insurance Company to the present, The First National Insurance Company will be transferred to the present, The First National Insurance Company by its amended name, The Industrial Life Insurance Company and will continue to be so operated unless and until it may be determined that the said The Industrial Life Insurance Company, successor in name to The First National Insurance Company can no longer legally operate as such and in that event purchasers have a right to exercise their option to operate under the charter of the present Industrial Life Insurance Company as herein provided, and in such event, if in the opinion of Clayton Seyphers and A. L. Seyphers, their executors, administrators and assigns, they are in a position to sell the charter of the present Industrial Life Insurance Company, purchasers shall have the option then and at all times from that time to the expiration of eight (8) years from the date hereof, of buying said charter at the price of Twenty Thousand ($20,000.00) Dollars payable one-half (1/2) cash and the remaining one-half (1/2) to be paid on the same terms as is provided herein for the deferred amount to be paid. Purchasers will use every reasonable effort to release this option at as early a date as may be practical in the judgment of their attorneys.

15. On or before March 1, 1953, party of the second part herein designated as purchasers, and Harry A. Turner, as General Manager, shall have the right and privilege of removing the said business from its home office now located at 1104 Taylor Street, Columbia, South Carolina, to such other location as the said purchaser may desire, and after removal thereof, purchaser and The First National Insurance Company, or its successors in name and in fact shall no longer be responsible for the payment of rents, light

bills, water bills, costs of heating or other expenses in connection with the offices now occupied by Industrial Life Insurance Company at 1104 Taylor Street, Columbia, South Carolina.

16. This sale is made upon the following specific conditions:

(a) That said party of the second part will assume all liability and full responsibility on all policy contracts in force, transferred to it by party of the first part, accruing from and after the transfer of said business to it, to wit: On or after February 2nd, 1953, and that the party of the second part will pay all just claims promptly, all legal reserve as it shall come due, all salaries of its employees and other obligations incurred by it as they come due.

(b) It is agreed that the sale price is based on the face of the debit as of February 2nd, 1953 and that the same has been checked by Mr. Harry A. Turner and is accepted as is, be it great or small.

(c) Party of the second part agrees to pay to party of the first part, Ten Thousand ($10,000.00) Dollars in cash, at the time of execution and delivery hereof, receipt of which is acknowledged by such execution and delivery.

(d) This sale and transfer of said business to The First National Insurance Company is made upon the condition that this is a conditional sales contract and seller reserves such an interest and title therein as will give to seller, and that seller has the right to collect the surplus profits and income therefrom, and from all additions thereto, and of all increase in business obtained by the First National Insurance Company or its successor, in name or in fact, and to be paid out whenever in the judgment of the Trustee said earned surplus and profits can safely be paid out from the business, until sellers have so collected and received the sum of Fifty Thousand ($50,000.00) Dollars in addition to the amount this day paid, together with interest on said Fifty Thousand ($50,000.00) Dollars and all unpaid portions thereof, at the rate of (3%) per cent per annum, from date until paid.

(e) Parties of the fourth part agree to deposit with J. M. Walker, Sr., as Trustee, all of the outstanding shares of capital stock of The First National Insurance Company as issued to them, assigned in blank, to be held by said Trustee, in escrow, upon the specific condition that if there is not paid to sellers from the said The First National Insurance Company or its successor, in name or in fact, a sufficient sum to cover said amount of Fifty Thousand ($50,000.00) Dollars, withdrawals, with interest at Three (3%) percent per annum, within eight (8) years from the date hereof, then the said Trustee shall deliver all of said shares of stock to seller and seller shall take possession of and have all the business of said company as is at that time, and parties of the fourth part shall not be personally liable thereon for any amount whatsoever. In case said full amount with interest is paid over to party of the first part within the said eight (8) years, then said stock certificates shall be returned to the respective owner thereof. In case the conditions of this provision are not fully performed while Mr. J. M. Walker, Sr., acts as Trustee, then and in that event, the Trust Department of the Citizens and Southern National Bank of Columbia, South Carolina is designated as Trustee instead of the said J. M. Walker, Sr., and said Trust Department shall act after the death or incapacity of J. M. Walker, Sr. The said payment shall be paid over to the present Industrial Life Insurance Company, or its successor, in name and in fact, at such place as may be directed in writing from time to time.

In case there is not paid over to party of the first part, to be applied on said Fifty Thousand ($50,000.00) Dollars above mentioned, by or before the end of the fourth year from the date hereof, the sum of Ten Thousand ($10,000.00) Dollars, together with all accrued interest thereon, then party of the second party agrees to forfeit all of its rights under this agreement and the Trustee is authorized to execute the assignments of capital stock herein referred to and deliver said stock in accordance with the provisions above written.

(f) If for any reason at any time within eight (8) years from the date hereof, parties of the fourth part cannot in the judgment of its attorneys, safely operate said business under the charter of the First National Insurance

Company, whether or not said charter is amended, then and in that event said parties shall have the right to continue to operate said business as, and under the charter and license of Industrial Life Insurance Company in accordance with the provisions of this agreement, until such time as arrangements may be made to take said business over under another charter or to buy the charter of Industrial Life Insurance Company if then available, but in no event for more than eight (8) years from the date hereof.

(g) That the present charter of Industrial Life Insurance Company, as amended, and by whatever name the said company shall be known, or any interest or share or shares of capital stock therein, shall not be sold, transferred, assigned, or disposed of by Clayton Scyphers and/or A. L. Scyphers except to the purchasers herein, for a period of eight (8) years from the date hereof, except as herein provided.

(h) The First National Insurance Company designated as party of the second part is that corporation as re-organized under the charter thereof, purchased at a sale had pursuant to an Order of the Court of Common Pleas for Richland County, and in the event said re-organization or the use of said charter be declared illegal, or if in the judgment of the Trustee or parties of the fourth part or their attorneys, it is not practical to operate thereunder, then this agreement is, and is hereby declared to be for the benefit of the parties of the fourth part, but in any event there shall not be any personal responsibility on the part of or liability against any of the parties of the fourth part, other than the amounts paid in by them for the purposes or reorganization of said corporation and this agreement which is Ten Thousand ($10,000.00) Dollars for capital and Thirty Thousand ($30,000.00) Dollars for operating surplus.

(i) In consideration of the personal ability and stability of each of the parties of the fourth part, it is agreed that parties of the fourth part will not sell or otherwise dispose of any or all of the stock or interest owned by either or all of said parties, nor will the management of the party of the second part be changed without the consent of the party of the first part and parties of the third part, or unless all of the amounts here provided to be paid are paid in full at the time of such sale or transfer.

(j) It is further agreed that Clayton Scyphers and A. L. Scyphers will not engage in any weekly premium insurance business in South Carolina within five (5) years from the date hereof without the written consent of party of the second part or its attorneys.

17. It is agreed that the parties of the first part will allow the party of the second part to operate its present office and facilities as is for a period of ninety (90) days or such portion thereof as may be desired by the the party of the second part with the understanding that such expenses that may be incurred by the party of the second part for such additional supplies contracted for by said General Manager and the maintenance and reserve accruing after January 5th, 1973, will be paid by the party of the second part.

18. It is further agreed that Clayton Scyphers will aid Harry A. Turner in an advisory capacity in any way he can as long as his physical condition will permit for a period of sixty (60) days without costs, and that hours and time shall be mutually agreeable.

19. Parties of the second part still further agree that no different type policy contracts will be issued unless and until they are actuarily sound. This provision continues until all withdrawals and payments herein provided for have been paid in full.

20. All cash bonds held by Industrial Life Insurance Company from its agents and employees are to be paid over and delivered to Harry A. Turner for the account of the party of the second party, and Industrial Life Insurance Company will pay its present agents and employees the amount of salary or pay held back with regard to each agent or employee.

21. That this agreement in all of its provisions and terms shall be binding upon and shall inure to the benefit of the signatory parties hereto and their respective heirs, executors, administrators, successors and assign. The use of the word seller or sellers shall apply to a party of the first part and parties of the third part whereso implied, and

the term purchaser or purchasers shall apply to party of the second part and parties of the fourth part, either or both whereso implied.

22. It shall be the duty of the Trustee to check and approve all new policy contracts. The Trustee shall have the right to see all reports coming before the Finance Committee, with authority to make recommendations to the Finance Committee as to all matters pertaining to the management of the affairs of party of the second part.

23. It is agreed that if for any reason any section paragraph, or clause in this agreement should be rendered illegal or void, it shall not destroy or affect the remainder of the contract.

24. It is agreed that party of the first part may keep in force at all time, not more than five (5) policies of not more than One Hunderd ($100.00) Dollars each on the members of the immediate family of Clayton Scyphers and A. L. Scyphers, except as herein provided in Section 14, Page 6.

25. It is further understood and agreed that this agreement in its present form, incorporates all the terms and conditions involving the sale and transfer of business and property as herein specified to the party of the second part.

IN WITNESS WHEREOF, this instrument is executed at Columbia, South Carolina this 2nd day of February, 1953. Signed, Sealed And Delivered

In the Presence Of:

/s/ A. D. SUTTON,

/s/ C. J. CLYBURN,

/s/ D. McK. WINTER, JR.,

/s/ D. McK. WINTER, SR.,
Parties of the Fourth Part.

INDUSTRIAL LIFE INSURANCE COMPANY,

By: /s/ CLAYTON SCYPHERS,
President,

/s/ A. L. SCYPHERS,
Secretary,

THE FIRST NATIONAL INSURANCE,
COMPANY,

By: /s/ HARRY A. TURNER,
President,

/s/ VERNON A. CROUT,
Secretary,

/s/ CLAYTON SCYPHERS,

/s/ A. L. SCYPHERS,
Parties of the Third Part.

/s/ HARRY A. TURNER,

/s/ VERNON A. CROUT,

/s/ ALTON K. AMICK,
Parties of the Fourth Part.

I consent to act as Trustee as herein provided for and to perform the conditions of said Trust or stake holder.

/s/ J. M. WALKER,
Trustee.

STATE OF SOUTH CAROLINA,
COUNTY OF RICHLAND.

PERSONALLY APPEARED Before me A. D. Sutton who being duly sworn says: That he saw the above named Industrial Life Insurance Company by Clayton Scyphers and A. L. Scyphers and The First National Insurance Company by Harry A. Turner and Vernon T. Crout, and Clayton Scyphers and A. L. Scyphers, parties of the third part, and Harry A. Turner, Vernon T. Crout, Alton K. Amick, D. McK. Winter, Jr., and D. McK. Winter, Sr., parties of the fourth part, sign, execute and deliver the foregoing instrument for the uses and purposes therein expressed and that he with C. J. Clyburn witnessed the execution thereof.

SWORN TO Before me this
6th Day of February, 1953.

/s/ A. D. SUTTON.

/s/ A. C. FITTS L. S.,
Notary Public for South Carolina,

Approved this 6th Day of February, 1953.

/s/ D. D. MURPHY,

Insurance Commissioner of South Carolina.

Civil Action No. 70-614

ORDER

This is an action brought by the plaintiff to recover income taxes and interest for the years 1963, 1964 and 1965, which it alleges were erroneously and excessively collected. The total amount of the claim is $41,037.35.

The case presents four basic questions, which are hereinafter answered in the Findings of Fact and conclusions of Law. These questions are:

1. Whether the plaintiff, during 1963, 1964 and 1965, qualified for taxation as a life insurance company under Section 801, *et seq.,* of the Internal Revenue Code of 1954.

2. Whether plaintiff allowed an unreasonable accumulation of earnings and is subject to the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code of 1954.

3. Whether plaintiff was engaged in the sale of lots in the ordinary course of its trade or business during the years 1963 and 1964, so that any gain resulting therefrom was subject to taxation at ordinary income rates.

4. Whether IRS properly disallowed certain claimed automobile expenses on the grounds that they were not incurred in the conduct of plaintiff's business.

After hearing all testimony, reviewing all exhibits and the various briefs and reply briefs submitted, the Court makes the following:

Findings of Fact

1. That plaintiff was chartered April 19, 1939, by the Secretary of State for South Carolina under the name of General Insurance Corporation, and through various name changes and amendments to the charter became Industrial Life Insurance Company on September 25, 1956.

2. That the original authorized capital stock of the corporation was $10,000.00 and that of this amount $2,500.00 was paid in.

3. That the Charter of the corporation empowers it to issue contracts of insurance against all manner of hazards, including sickness, accident, death, casualty and liability, and all other forms of insurance contracts; to buy, sell, mortgage, and lease real estate and to do all things necessary and incident to the above powers.

4. That during 1942 control of the plaintiff corporation was acquired by Clayton Seyphers and his immediate family, who now own all the company stock, constitute its Board of Directors and serve as its officers.

5. That on or about May 20, 1969, the plaintiff paid to the defendant the sum of $41,037.35, being the amount assessed by the defendant as additional income tax and interest

due by the plaintiff for the years 1963, 1964 and 1965 as follows:

1963 tax	$13,206.87
Interest	4,103.20
TOTAL	$17,310.00
1964 tax	$15,119.87
Interest	3,768.59
TOTAL	$18,888.46
1965 tax	$ 4,063.47
Interest	775.35
	$ 4,838.82

6. That plaintiff filed timely claim for refund, after paying such taxes under protest and such claim for refund was rejected by the defendant. The suit was brought pursuant to the provisions of 28 U. S. C. A. 1346 for recovery of these amounts.

7. In the early years of the corporation it actively engaged in the business of writing weekly premium insurance. The weekly premium business was disposed of through reinsurance agreements and since 1956 the only insurance sold by the plantiff has consisted of a credit life insurance policy on the lives of the debtors of Consumer Investment Company, Inc., issued March 1, 1962. This was a master group credit life insurance policy, and separate policies were not issued by the plaintiff to the individual debtors. Only debtors below the age of 65 years were covered. The maximum amount on one debtor was $2,000.00 and the length of the indebtedness could not exceed 36 months.

8. The evidence shows that there were from one thousand to twelve hundred debtors insured from time to time under this blanket policy and the average loan insured was approximately $250.00

9. The premium income resulting from this credit life insurance blanket policy was $2,572.46 in 1963, $3,517.56 in 1964 and $3,423.92 in 1965.

10. During the years 1963, 1964 and 1965 Industrial Life Insurance Company paid premiums to itself on poli-

cies of life insurance on the lives of certain officers of the corporation, all of whom are members of the Scyphers family (Mr. Clayton Scyphers, his wife and his son), and the plaintiff was the beneficiary under said policies. The amounts paid in premiums for the respective years on these key man insurance policies were $3,561.25, $3,236.95 and $6,992.00. On these policies the plaintiff was not only the insurer and the beneficiary, but also paid the premiums.

11. During 1963 and 1964 the plaintiff had annual income from weekly premium, Industrial Life policies on members of the Scyphers family of $83.20 and $41.60. No such income was received during the year 1965.

12. The total premium income for the three taxable years was 1963—$6,216.91, 1964—$6,796.11 and 1965—$10,415.92.

13. During the tax years in question, the plaintiff did not maintain a sales force, its office was located in the home of its president, Mr. Clayton Scyphers, and its primary income has been from the sale of real estate lots, rental of real estate and management of its investment portfolio. The activities of the corporation may best be shown from the following comparison of premium and investment income.

COMPARISON OF PREMIUM AND INVESTMENT INCOME

	1963	*1964*	*1965*
Premium Income	$ 6,216.91	$ 6,796.11	$10,415.92
Other Income			
Interest:			
On Mortgages	7,431.30	8,346.85	8,955.24
Miscellaneous	56.09	....	....
Consumer Investment	1,234.37	2,400.00	2,483.08
Bldg. & Loan	833.75	1,685.05	2,897.82
Rents	4,965.12	5,982.45	6,055.12
Sale of lots	20,000.00	22,000.00	....
Capital gain—installment sale	204.77	221.25	....
Total Investment Income	$34,725.40	$40,635.60	$20,391.26

COMPARISON OF SOURCE OF PREMIUM INCOME

	1963	*1964*	*1965*
Family premiums	$ 3,644.45	$ 3,278.55	$ 6,992.00
Other premiums	2,572.46	3,517.56	3,423.92

14. In 1948 plaintiff bought 504 acres of land in Kershaw County, South Carolina as an investment. Part of this tract has been subdivided into residential lots and the above figures reflect $20,000.00 in 1963 and $22,000.00 in 1964 from the sale of such lots. In 1963 the plaintiff by three separate deeds conveyed to Clayton Scyphers eleven lots from this tract. In 1964 by one deed the plaintiff conveyed to Clayton Scyphers eleven lots out of this tract.

15. Prior to 1963 the real estate sales by plaintiff totaled thirteen in 1956, two in 1957, three in 1958, nine in 1959, four in 1950, eight in 1961 and three in 1962. Some of these sales covered more than one lot. Prior to 1963 there were no sales to Clayton Scyphers or members of his family. Prior to beginning the sale of residential lots out of the 504 acre tract, plaintiff obtained permission from the South Carolina Insurance Commission. On the lots sold to Clayton Scyphers, homes were constructed by him and sold.

16. The real estate, originally purchased as an investment, became property held for sale in the ordinary course of business due to the continued sale and development, and the large part of plaintiff's income resulting from such sales.

17. Since the time the Scyphers family obtained control of the plaintiff corporation, it has not paid a dividend. Earnings and profits have been accumulated, and the unassigned surplus account at the end of each of the years in suit was $232,765.41 for 1963, $260,018.06 for 1964 and $269,099.38 for 1965.

18. Plaintiff has shown no reasonable needs of the business to justify the continued accumulation of earnings and profits. It has been contended that these accumulations are necessary under requirements of South Carolina State Law (§ 37-181, 183 Code of Laws of South Carolina 1962) which provide minimum initial capital and surplus of $600,000.00. This figure is now required only of new insurance companies and does not apply to the plaintiff, which was chartered in 1939.

19. If the plaintiff is concerned about a possible change in the South Carolina law which would require its capital and surplus to be increased to $600,000.00, it is obvious that

at the present rate of earnings accumulation, the plaintiff will not reach this figure for many, many years. If plaintiff really desired to build up its capital and surplus, it should increase its premium income by sale of insurance policies and its capital base by the sale of additional stock.

20. Plaintiff maintained and owned an automobile which was used by its president Mr. Clayton Scyphers for both business and personal uses. Due to the limited nature of plaintiff's business activities, it is found that not more than 25% of the automobile expenses were incurred in the conduct of plaintiff's business.

Conclusions of Law

1. Plaintiff was not a life insurance company within the meaning of the Internal Revenue Code of 1954 during the years 1963, 1964 and 1965.

The plaintiff mistakes the right to tax a life insurance company with the right to regulate such company. It contends that the McCarran Act, 15 U. S. C. A. 1011 clearly demonstrates the intent of Congress to leave regulation of insurance companies to the respective states. Since the plaintiff is chartered by the State of South Carolina as a life insurance company, files reports with and is regulated by the South Carolina Insurance Commission, plaintiff argues that the Federal Government may not contend otherwise. In the McCarran Act it is stated:

> "Congress declares that the continued regulation and taxation by the several states of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several states."

Congress did not give up the right to tax insurance companies by passing the McCarran Act. Prior to 1921, insurance companies were taxed as ordinary corporations, but by the Revenue Act of 1921 Congress established a different method for taxing insurance companies, which methods, with some modification, have prevailed to this date. By establishing special taxing systems for insurance companies, because their premium and investment income differs from the income of manufacturing companies and other corporations, Congress had the right and power to decide what companies would be considered as insurance companies for tax purposes and enjoy the benefits of this legislation. Congress also had the power to decide which companies within the insurance industry would be treated by the Internal Revenue Service as life insurance companies, since their requirements differed from casualty insurance companies. 26 U. S. C. A. 801 *et seq.*, provides for the taxation of life insurance companies by the United States of America.

In Section 801(a) life insurance companies are defined:

> "For purposes of this subtitle, the term 'life insurance company' means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), or noncancellable life, health or accident policies not included in the life insurance reserves.
>
> comprise more than 50 percent of its total reserves (as defined in subsection (c))."

Before a company may be classified under the above section as a life insurance company, it is necessary to determine if it is an insurance company, since this is the first requirement mentioned. The Internal Revenue Code does not define the term "insurance company", but Treasury Regulations on Income Tax (1954 Code), Section 1.801.3 (a) provides:

> "(1) The term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks under-

> written by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code."
>
> "Section 1.801-3(2)(b) Life Insurance Company. (1) The terms 'life insurance company' as used in subtitle A of the Code, is defined in Section 801(a). For the purpose of determining whether a company is a 'life insurance company' within the meaning of that term as used in Section 801(a), it must first be determined whether the company is taxable as an insurance company (as defined in paragraph (a) of this section). . . ."

Treasury Regulations have the force and effect of law and provide a standard to be followed in determining plaintiff's classification under the Internal Revenue Code. It is apparent that the nature and character of the business actually done in a particular tax year is controlling on whether a company is to be treated as an insurance company under the law. The test is applied on a year to year basis, so it is possible for a company to qualify as a life insurance company in one year, but not in the preceding or succeeding years.

The basic question presented is whether the issuance of insurance contracts by the plaintiff constituted its primary and predominant business activity in 1963, 1964 and 1965. It is obvious from the financial information contained in Finding of Fact No. 13 that premium income for these years was small when compared with income from real estate, mortgages and investment.

It is also important to note that more than half of the premium income came from policies on the lives of the only officers and stockholders of the company. The only insurance contract written on persons outside the family was the group credit policy, which was issued prior to the years in suit. Although there was a sizable increase in premium income in the year 1965, all of this increase is attributable to members of the Scyphers family, which means that the plaintiff was buying additional insurance from itself insuring the lives of its officers and stockholders. Since this "key man" insurance was kept by the plaintiff and not reinsured with another company, the death of one of the members of the family, insured under a policy with plaintiff, would mean only a bookkeeping entry to the plaintiff, since the money would simply be transferred from one account to another, because the plaintiff is also the beneficiary.

One of the examples cited under Regulation 1.801-1 (b) (2) is quite helpful in the present facts. It provides as follows:

> "For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance corporation for the year 1954 within the meaning of the Code and the regulations thereunder."

The plaintiff relies heavily upon the case of *Alinco Life Insurance Company v. United States*, 373 F. (2d) 336 (Ct. of Claims 1967). A close examination of *Alinco* reveals that it is primarily a decision involving qualification as a life insurance company. The only business of *Alinco* was reinsuring certain risks under a reinsurance treaty with another insurance company. Even though *Alinco* did business with only one carrier, the risk during the tax year involved amounted to almost one billion dollars. Its sole business activity was in the reinsurance field and it did not have the majority of its income coming from real estate, mortgages, dividends and interest. *Alinco* was also serving a legitimate business purpose of its owner, a large finance company, since the owner could not engage in the insurance business under the laws of the state under which it was incorporated.

The case of *Cardinal Life Insurance Company v. United States of America* (N. D. Tex. 1969), 300 F. Supp. 387[1] is quite similar to the present facts, since Cardinal was duly licensed and chartered to do business in the State of Texas as a life insurance company, but did not maintain an active sales force soliciting and selling policies and its premium income represented a very small part of its total income. The remainder of its income came from interest, capital gains, rent and dividends. In *Cardinal*, the Court stated:

> "It should be noted that the name of the company, the charter powers and subjection to State insurance laws are significant only in ascertaining the business which the company is authorized to conduct. Whether the plaintiff is to be classed as a life insurance company for federal taxation purposes is determined by the character of the business actually done during the taxable year. *Bowers v. Lawyers Mortgage Co.*, 285 U. S. 182 (1932). Thus, to qualify as a life insurance company under the federal tax laws, a corporation must use its capital and efforts *primarily* in earning income from the issuance of contracts of insurance. See *Louisville Title Company v. Lucas*, 27 F. (2d) 413 (W. D. Ky.). Moreover, the test is to be applied to the taxpayer on a year by year basis.
>
> The question presented to the Court in this case then is whether the issuance of insurance contracts by plaintiff constitutes its **primary** and **predominant** business activity during each of the taxable years involved. A review of the schedule of business activities set forth above clearly indicates that plaintiff was not 'primarily and predominately' in the business of issu-

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[1] On appeal from the United States this case was reversed in 425 F. (2d) 1328 (5th Cir. 1970). The reversal was on the ground of the district judge's misinterpretation of the Statute of Limitations and allowed government to go back three additional years and not on any ground having to do with the insurance question.

> **ing life insurance contracts during any of the years involved in this action. . ."**

In the *Lawyers Mortgage Co.* case, *supra,* the premium income of the taxpayer constituted about 35 percent of its total income, yet the Supreme Court held that it was not primarily in the insurance business within the meaning of the term "insurance company", as used by Congress. The premium income of Industrial Life is less than 20 percent of its total income, and when premiums on policies of the Scyphers family are omitted, premium income amounts to approximately 8 percent of the total for the years in question.

The Court concludes that for the years 1963, 1964 and 1965 the plaintiff was not a life insurance company under Section 801, *et seq.* of the Internal Revenue Code of 1954, since its primary and predominate business activity during these years was not issuing insurance or annuity contracts or reinsuring the risks underwritten by other insurance companies.

2. The plaintiff allowed its earnings to accumulate beyond the reasonable needs of the business and is therefore subject to the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code of 1954. Sections 531, 532 and 533 provide, in part, as follows:

> "Section 531. Imposition of Accumulated Earnings Tax
>
> In addition to the other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in Section 535) of every corporation described in Section 532, an accumulated earnings tax equal to the sum of
>
> (1) 27-1/2 percent of the accumulated taxable income not in excess of $100,000.00, plus
>
> (2) 38-1/2 percent of the accumulated taxable income in excess of $100,000.00.
>
> Section 532. Corporation Subject to Accumulated Earnings Tax

> (a) General Rule. The accumulated earnings tax imposed by Section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed. . .
>
> Section 533. Evidence of Purpose to Avoid Income Tax
>
> (a) Unreasonable accumulation determinative of purpose. For the purposes of Section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary. . ."

The taxpayer argues that since its stockholders are in a lower income tax bracket than the corporation, it is unlikely that the taxpayer has accumulated its earnings to avoid "the income tax with respect to its shareholders". This argument has no merit. The purpose of the accumulated earnings tax can be no better expressed than by the language of Section 532 above. It is recognized that a corporation's normal objective is not only to earn profits, but to pass these profits on to its shareholders in the form of dividends. Regardless of the shareholders tax bracket, as compared to the corporation, dividends are taxed twice—once as the earnings of the corporation and again as a part of the taxable income of the shareholder.

This statutory restriction on the use of corporations to avoid income taxes of its shareholders is necessary when one considers the steeply graduated tax rates for individuals and compares them to the maximum tax rate for corporations. A corporation may be used to shield income when it is earned, and by accumulation of its earnings to avoid, either entirely or partially, the tax that would normally fall upon distribution to its shareholders.

Usually it is impossible to find the unanimity of interest among stockholders necessary to limit or abolish the payment of dividends except in family or closely held corporations. If dividends are not paid and the individual income tax thereon is not received, the tax law, through 531, collects these funds directly from the corporation when there has been an accumulation.

As stated in *Helvering v. National Grocery Co.* 304 U. S. 282, 286 (1938):

> "The Statute in no way limits the powers to declare or to withhold dividends of the corporation. It merely lays the tax upon corporations which use their powers to prevent imposition upon their stockholders of the Federal surtaxes."

It is not necessary that "the purpose of avoiding the income tax with respect to its shareholders" be the sole, the primary or the dominant purpose for the accumulation. It is sufficient that such purpose be one of the motives which prompt the accumulation beyond the reasonable needs of the business. *United States v. Donruss Co.* 393 U. S. 297 (1969).

Section 533(a) places the burden upon the corporation to prove by the preponderance of the evidence that such accumulations are not beyond the reasonable needs of the business. The plaintiff has failed to carry this burden. As pointed out in Finding of Fact No. 19, if plaintiff really wished to increase its capital and surplus there are other and more effective methods to accomplish this.

To justify such an accumulation, the need must be treated with economic reality. It is not sufficient for a taxpayer to merely recognize the problem and discuss it. "Definiteness of plan coupled with action taken toward its consumation are essentials." *Dixie, Inc., v. Commissioner* 277 F. (2d) 526, 528 (2nd Cir. 1960).

3. The plaintiff was engaged in the sale of lots in the ordinary course of its trade or business during the years 1963 and 1964 and the gain resulting therefrom was subject to taxation at ordinary income tax rates.

Although the taxpayer originally purchased the land in Kershaw County as an investment, the corporation's purpose changed when it began to develop, subdivide and sell lots. This is particularly true in this case where the other activities of the corporation were so limited in scope and income. However, this property later became an asset held for sale in the ordinary course of business.

Since the capital gain statutes provide an exception to and reduction of the normal tax rates, they are to be narrowly construed. *Corn Products Co. vs. Commissioner* 350 U. S. 46 (1955). The frequency and continuity of sales by the plaintiff is demonstrated by the findings of fact in 14 and 15 above. It is obvious that these transactions were not "isolated" but show a pattern in the development and sale of lots. Although the property may have been bought as an investment, the real question is decided by the purpose for which it is being held at the time of the sale. Acquisition of property as an investment is not inconsistent with the later holding of the same property for sale to customers in the ordinary course of business. See *Ackerman vs. United States* 335 F. (2d) 521 (5th Cir. 1964) and *Bauschard vs. C. I. R.* 279 F. (2d) 115 (6th Cir 1960).

4. The automobile owned by the taxpayer and used by its president was not used more than 25 percent in the conduct of its business, and the expenses disallowed by Internal Revenue Service for such expenses are proper.

The testimony shows that the plaintiff provides its president with an automobile, which was used both for conducting the plaintiff's business as well as the president's personal and family pleasure. The office of the plaintiff was located in the home of its president and due to the very limited activities of the plaintiff, only a small amount of automotive travel was required. The plaintiff owned real estate in Kershaw County, a distance of only 20 to 25 miles from plaintiff's office, and trips to this property were not required on any regular or frequent basis.

Under Section 162 (a) of the Internal Revenue Code, a deduction is allowed for all "ordinary and necessary expenses" paid or incurred in carrying on a trade or business.

The operation of an automobile used in the business falls within this classification, but this does not include the use of said automobile for the personal affairs of an officer or employee of the corporation. The only reasonable inference to be drawn from the evidence in this case is that the Internal Revenue Service was generous in allowing the plaintiff to deduct 25 percent of the expenses in connection with the operation of said automobile.

IT IS, THEREFORE, ORDERED that this case be **and the same is hereby dismissed with costs.**

/s/ ROBERT F. CHAPMAN
United States District Judge

April 11, 1972
Florence, South Carolina

True Copy?

CLERK'S MEMORANDUM

Enclosed is a copy of the opinion. Judgment was entered on July 3, 1973. Counsel desiring to tax costs against the unsuccessful party under Rule 39, FRAP, is requested to furnish an itemized statement from the printer showing the actual cost per page for reproducing the brief and appendix.

WILLIAM K. SLATE, II,
Clerk.

Supreme Court of the United States

FOR THE FOURTH CIRCUIT

No. 72-1693

INDUSTRIAL LIFE INSURANCE COMPANY,
APPELLANT,

versus

UNITED STATES OF AMERICA, APPELLEE

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF SOUTH CAROLINA, AT COLUMBIA. ROBERT F. CHAPMAN, DISTRICT JUDGE.

Argued June 4, 1973 Decided July 3, 1973

Before WINTER, BUTZNER, and FIELD, Circuit Judges.

Harry S. Dent and Henry H. Taylor (Whaley, McCutchen, Blanton and Dent on brief) for Appellant; Scott P. Crampton, Assistant Attorney General (Meyer Rothwacks, Thomas L. Stapleton and Janet R. Spragens, Attorneys, Tax Division, United States Department of Justice, John K. Grisso, United States Attorney, and Charles W. Gambrell, Assistant United States Attorney, on brief) for Appellee.

PER CURIAM:

We see no error in the district court's dismissal of taxpayer's suit for a refund of taxes.

The district court correctly determined, as a matter of fact, that taxpayer was not a "life insurance company" within the meaning of 26 U. S. C. § 801(a), because it was not an "insurance company" within the meaning of Treasury Regulation 1.801-3(a). We think the regulation valid and simply a restatement of existing law. *Bowers v. Lawyers Mortgage Co.,* 285 U. S. 182 (1932). The regulation does not conflict with the McCarran Act, 15 U. S. C. § 1011 *et seq.,* because the power of the federal government to tax was not delegated to the states. The district court's determination that taxpayer failed to show a "specific, definite and feasible plan" to justify its accumulation of earnings was not clearly erroneous. *Inland Terminals v. United States,* —— F. (2d) —— (4 Cir. April 26, 1973).* Finally, the district court's determination that taxpayer was selling land in the ordinary course of business so as to subject profits therefrom to taxation as ordinary income was not clearly erroneous.

AFFIRMED.

AFFIDAVIT

Personally appeared before me, John Carl West, of 800 Block of Richland Street, in the Governor's Mansion, Columbia, South Carolina, who being duly sworn, deposes and says:

THAT he was a relatively young lawyer in Camden, South Carolina, about the year 1948 or 1949, and that Clayton Scyphers, as a representative of an insurance company, which company owned the land, tried very hard to sell a real estate agent by the name of Red Stogner and myself, John Carl West, approximately 500 acres of raw land located in Lugoff, South Carolina, near Camden, later became to be known as Mayfield Acres Subdivision. At the time of the proposed sale, no streets, no water lines, no gas lines, and no telephone lines had been installed, and no subdividing had been done; it was strictly raw farm land. After long and careful consideration, I rejected the offer to buy this property, but through no fault of Mr. Scyphers, this land was not sold as a whole at that time.

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* Both in oral argument and in post-argument documentation, taxpayer asserts that certain statutory changes upgrading the capital and surplus requirements of insurance companies like taxpayer were contemplated in the tax years in question and were subsequently enacted in part. The major changes did not become effective until after the tax years in question and, in any event, the record fails to show that earnings were accumulated as part of a plan to meet threatened pending legislation.

/s/ JOHN CARL WEST

SWORN to and subscribed before
me this 31st day of May, 1972.

/s/ MARY JUNE FOLD
NOTARY PUBLIC of South Carolina

My Commission expires 2-16-82

Taxpayer's Note: This Affidavit was not offered as evidence in the District Court but is offered here to confirm the testimony of the taxpayer's president that he tried very hard to sell this property as a whole, and after failing, sought permission from the South Carolina Chief Insurance Commissioner of the S. C. regulatory authority to sell it off in lots until it could be developed to such an extent that he could sell it as a going subdivision which has now been done.

We quote from the government's regulation 1.801-3 (a)(1) based on *Bowers v. Lawyers Mortgage Co.*, 285 U. S. 182 (1932) which used these words and it has not been reversed since the *Bowers* case:

> "It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code."

IMPORTANT TAXPAYER'S NOTE: This provision of this regulation did not attempt to change the 50% life reserve test of Section 801.

No evidence of Real Estate sales beyond the three tax years was admissible because they were barred by the statute of limitations and this regulation.

AFFIDAVIT

Personally appeared before me, Robert B. Russell, of Charleston County, South Carolina, who being duly sworn, deposes and says:

THAT about the year 1948 or 1949, Clayton Scyphers, as a representative of an insurance company, which company owned the land, tried very hard to sell Ruscon Construction Company, of which I operate, approximately 500 acres of raw land located in Lugoff, S. C., near Camden, later became to be known as Mayfield Acres Subdivision. At the time of the proposed sale, no streets, no water lines, no gas lines, and no telephone lines had been installed, and no subdividing had been done; it was strictly raw farm land. After long and careful consideration, I rejected the offer to buy this property, but through no fault of Mr. Scyphers, this land was not sold as a whole at that time.

/s/ ROBERT B. RUSSELL.

SWORN to and subscribed before
me this 22nd day of June, 1972.

. . . . ,
NOTARY PUBLIC of South Carolina.

My Commission expires Aug. 1, 1978.

Taxpayer's Note: This Affidavit was not offered as evidence in the District Court but is offered here to confirm the testimony of the taxpayer's president that he tried very hard to sell this property as a whole, and after failing, sought permission from the South Carolina Chief Insurance Commissioner of the S. C. regulatory authority to sell it off in lots until it could be developed to such an extent that he could sell it as a going subdivision which has now been done. See Record Transcript p. 33 and p. 35.

We quote from the government's regulation 1.801-3(a)(1) based on *Bowers v. Lawyers Mortgage Co.,* 285 U. S. 182 (1932) which used these words and it has not been reversed since the *Bowers* case:

> "It is the character of the business actually done in the taxable year which determines whether a company

is taxable as an insurance company under the Internal Revenue Code."

IMPORTANT TAXPAYER'S NOTE: This provision of this regulation did not attempt to change the 50% life reserve test of Section 801.
No evidence of Real Estate sales beyond the three tax years was admissible because they were barred by the statute of limitations and this regulation.

AFFIDAVIT

Personally appeared before me, J. Bonner Baxter, of Richland County, South Carolina, who being duly sworn, deposes and says:

THAT about the year 1949 he had resigned from the Federal Housing Administration as Chief Underwriter and became President of the Great Southern Insurance Company of Columbia, South Carolina; that Clayton Scyphers, as a representative of an insurance company which had approximately 500 acres at Lugoff, S. C., which had been purchased as an investment for the insurance company, near the huge DuPont operation, approached me and said that the insurance company would like to dispose of it succesfully as a whole for its true value. After several conferences and on the site inspections with him, and knowing that he had failed to sell it as a whole for its true value to the now Governor John C. West, then a relatively young lawyer in Camden, and knowing that he had failed to sell it to R. B. Russell in Charleston, who operates a large construction company, known as Ruscon Construction Company, and for all practical purposes, the land was strictly raw land because it had no pavement, no water lines, no gas lines, no curb and gutter, nor sewer, nor any telephone lines. By reason of these conditions, it was my recommendation to Mr. Scyphers that as a last resort he get permission from the Insurance Commission to allow him to buy some lots at VA and FHA appraisal value and develop a few houses on this property until he could receive its fair ing been in the mortgage business for many years and an official of the Federal Housing Administration for ten value as a going subdivision. It is my judgment after hav-

years, that Mr. Scyphers has done exactly what I recommended and that he has now sold the remainder of the property as a whole and which he could not do before some development had been done. I am not sure at all, knowing the operation as I did that Mr. Scyphers made any personal money out of the building operation because I know that the Internal Revenue Service made him pay short term gains as a real estate operator, when in fact he was merely following my suggestion, all for the benefit of the insurance company, which in my judgment was strictly an incident to the insurance company's charter powers.

/s/ J. BONNER BAXTER.

SWORN to and suubscribed before
me this 6th day of June, 1972.

................................,
NOTARY PUBLIC of South Carolina.

My Commission expires October 8, 1979.

Taxpayer's Note:

The purpose of these three letters, even though they were not introduced in evidence, is a matter of corroboration of verification that the president tried very hard to sell this property as a whole and only built these houses personally by reason of the advice of J. Bonner Baxter, probably the greatest living authority in South Carolina on V. A. and F. H. A. or government financing and to help the insurance company, and not himself. See R. transcript pages 33 and 35.

We quote from the government's regulation 1.801-3(a)(1) based on *Bowers v. Lawyers Mortgage Co.*, 285 U. S. 182 (1932) which used these words and it has not been reversed since the *Bowers'* case:

> "It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code."

IMPORTANT TAXPAYER'S NOTE: This provision of this regulation did not attempt to change the 50% life reserve test of Section 801.

No evidence of Real Estate sales beyond the three tax years was admissible because they were barred by the statute of limitations and this regulation.

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No. 73-676

In the Supreme Court of the United States

OCTOBER TERM, 1973

INDUSTRIAL LIFE INSURANCE COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS FOR
THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-676

INDUSTRIAL LIFE INSURANCE COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner urges here, as it did in the courts below, that during its taxable years 1963, 1964 and 1965, it was taxable as a "life insurance company" within the meaning of Section 801(a) of the Internal Revenue Code of 1954; that it was not liable for the accumulated earnings tax imposed by Section 531 of the Code; and that it was entitled to capital gains treatment on the sale of certain real estate lots owned by it because it held such lots as "capital assets," as defined in Section 1221 of the Code. Both the district court (Pet. App. 170-181) and the court of appeals (Pet. App. 183-184) decided each of these factual issues adversely to petitioner.

Petitioner does not allege that the decision below is in conflict with that of any other circuit. To the contrary, it simply restates the arguments with respect to these factual determinations which were correctly rejected by both courts below.

1. Petitioner was not a life insurance company within the meaning of Section 801(a) of the Code, because during the taxable years in issue its primary and predominant business activity was not the issuance insurance contracts.[1] See Treas. Reg. § 1.801-3(a); *Bowers* v. *Lawyers Mortgage Co.*, 285 U.S. 182. The evidence showed (Pet. App. 170-171, 175, 178) that premium income in each of the years in issue was exceedingly small when compared to business income from other sources. Moreover, a substantial portion of the small premium income was attributable to policies on the lives of petitioner's officers (Pet. App. 170-171).

2. The evidence also amply justified the conclusion that petitioner was liable for the Section 531 accumulated earnings tax. The district court found that petitioner had accumulated earnings of $232,765.41 (1963), $260,018.06 (1964), and $269,099.38 (1965), and that it had shown no reasonable business need for this accumulation (Pet. App. 172). Although petitioner argues (Pet. 57-70) that it had a reasonable business need for these accumulations in the sum of $600,000 because of capitalization requirements under state law, the district court noted (Pet. App. 172) that it was exempted from those requirements. Similarly, the court

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[1] Petitioner errs in suggesting (Pet. 31-52) that the Act of March 9, 1945, 59 Stat. 33 (15 U.S.C. 1011 *et seq.* (commonly known as the McCarran Act)) altered this test. See *Modern Life & Accident Ins. Co.* v. *Commissioner*, 420 F. 2d 36 (C.A. 7).

of appeals observed (Pet. App. 184, note) that "the record fails to show that earnings were accumulated as part of a plan to meet threatened pending legislation." It is therefore beyond question that petitioner permitted its earnings and profits to accumulate beyond its reasonable business needs, and failed to meet its burden under Section 533(a) of the Code to demonstrate that the purpose behind such accumulation was not the avoiding of income tax upon its shareholders.

3. Finally, the record supports the conclusion of both courts below that petitioner "was engaged in the sale of lots in the ordinary course of its trade or business during the years 1963 and 1964" and was therefore taxable on the gains from these sales at ordinary income rates under Section 1221(1) of the Code. The district court found that the real estate had been originally purchased for investment purposes, but that petitioner thereafter changed its purpose, and that this change was evidenced by petitioner's subdivision of part of the tract, its numerous sales of individual lots prior to the taxable years in issue, and the fact that petitioner's primary income during the taxable years 1963 and 1964 arose from the sale of lots (Pet. App. 171-172).[2]

It is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

DECEMBER 1973.

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[2] Petitioner errs in suggesting (Pet. 74-80) that the district court improperly failed to make a specific finding that it held the real estate "*primarily* for sale to customers in the ordinary course of his trade or business." There was no need for such a finding because the evidence showed that petitioner held the real estate for only one purpose during the years in issue. Cf. *Malat* v. *Riddell*, 383 U.S. 569.